

DEPARTMENT OF THE TREASURY  
Internal Revenue Service  
26 CFR Part 1

**REG-111283-11**  
**Swap Exclusion for Section 1256 Contracts**

RIN 1545-BK22

AGENCY: Internal Revenue Service (IRS), Treasury.

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

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**SUMMARY:** This document contains proposed regulations that describe swaps and similar agreements that fall within the meaning of section 1256(b)(2)(B) of the Internal Revenue Code (Code). This document also contains proposed regulations that revise the definition of a notional principal contract under Sec. 1.446-3 of the Income Tax Regulations. This document provides a notice of public hearing on these proposed regulations.

**DATES:** Written or electronic comments must be received by December 15, 2011. Outlines of topics to be discussed at the public hearing scheduled for January 19, 2012, must be received by December 14, 2011.

**ADDRESSES:** Send submissions to: CC:PA:LPD:PR (REG-111283-11), Room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington DC 20044. Submissions may be hand delivered Monday through Friday, between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-111283-11), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Federal eRulemaking Portal at <http://www.regulations.gov/> (IRS-REG-111283-11). The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Concerning the proposed regulations, K. Scott Brown (202) 622-7454; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Richard Hurst, (202) 622-7180 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

**Background**

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 1256 and 446 of the Code. Section 1256(b)(2)(B) was added to the Code by section 1601 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203, 124 Stat. 1376, 2223 (2010)) (the Dodd-Frank Act). Section 1256(b)(2)(B) provides that certain swaps and similar agreements are not subject to section 1256 of the Code. These proposed regulations provide guidance on the category of swaps and similar agreements that are within the scope of section 1256(b)(2)(B). These proposed regulations also revise the definition and scope of a notional principal contract under Sec. 1.446-3 of the Income Tax Regulations.

## Explanation of Provisions

### A. Section 1256(b)(2)(B) Language and Legislative History

Section 1256 provides that contracts classified as section 1256 contracts are marked to market and any gain or loss is generally treated as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss. Section 1256(b)(1) defines the term “section 1256 contract” as a regulated futures contract, foreign currency contract, nonequity option, dealer equity option, and dealer securities futures contract. With the exception of a foreign currency contract, a section 1256 contract must be traded on or subject to the rules of a “qualified board or exchange” as defined in section 1256(g)(7).

Section 1601 of the Dodd-Frank Act added section 1256(b)(2)(B), which excludes swaps and similar agreements from the definition of a section 1256 contract. Section 1256(b)(2)(B) provides that the term “section 1256 contract” shall not include--  
any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.

Congress enacted section 1256(b)(2)(B) to resolve uncertainty under section 1256 for swap contracts that are traded on regulated exchanges. The specific uncertainty addressed by the enactment of section 1256(b)(2)(B) was described in the Conference Report:

The title contains a provision to address the recharacterization of income as a result of increased exchange-trading of derivatives contracts by clarifying that section 1256 of the Internal Revenue Code does not apply to certain derivatives contracts transacted on exchanges.

H.R. Conf. Rep. No. 111-517, at 879 (2010).

Section 1256(b)(2)(B) contemplates that a swap contract, even if traded on or subject to the rules of a qualified board or exchange, will not be a section 1256 contract.

### B. Scope of Swaps Excluded by Section 1256(b)(2)(B)

#### 1. Notional Principal Contracts and Credit Default Swaps

Congress incorporated into section 1256(b)(2)(B) a list of swaps that parallels the list of swaps included under the definition of a notional principal contract in Sec. 1.446-3(c) with the addition of credit default swaps. The parallel language suggests that Congress was attempting to harmonize the category of swaps excluded under section 1256(b)(2)(B) with swaps that qualify as notional principal contracts under Sec. 1.446-3(c), rather than with the contracts defined as “swaps” under section 721 of the Dodd-Frank Act. Accordingly, Sec. 1.1256(b)-1(a) of the proposed regulations provides that a section 1256 contract does not include a contract that qualifies as a notional principal contract as defined in proposed Sec. 1.446-3(c). As discussed herein, the proposed regulations under Sec. 1.446-3 also expressly provide that a credit default swap is a notional principal contract.

#### 2. Option on a Notional Principal Contract

Section 1256(b)(2)(B) raises questions as to whether an option on a notional principal contract that is traded on a qualified board or exchange would constitute a “similar agreement” or would instead be treated as a nonequity option under section 1256(g)(3). Since an option on a notional principal contract is closely connected with the underlying contract, the Treasury Department and the IRS believe that such an option should be treated as a similar agreement

within the meaning of section 1256(b)(2)(B). Accordingly, Sec. 1.1256(b)-1(a) of the proposed regulations also provides that a section 1256 contract does not include an option on any contract that is a notional principal contract defined in Sec. 1.446-3(c) of the proposed regulations.

### 3. Ordering Rule

The proposed regulations provide an ordering rule for a contract that trades as a futures contract regulated by the Commodity Futures Trading Commission (CFTC), but that also meets the definition of a notional principal contract. The Treasury Department and the IRS believe that such a contract is not a commodity futures contract of the kind envisioned by Congress when it enacted section 1256. Accordingly, Sec. 1.1256(b)-1(a) of the proposed regulations provides that section 1256 does not include any contract, or option on such contract, that is both a section 1256 contract and a notional principal contract as defined in Sec. 1.446-3(c) of the proposed regulations.

### C. Definition of Regulated Futures Contract

Section 1256(g)(1) defines a regulated futures contract as “a contract (A) with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market, and (B) which is traded on or subject to the rules of a qualified board or exchange.” The apparent breadth of section 1256(g)(1) has raised questions in the past as to whether a contract other than a futures contract can be a regulated futures contract. The Treasury Department and the IRS have historically limited the scope of a regulated futures contract to those futures contracts that have the characteristics of traditional futures contracts. Under the Dodd-Frank Act, a “designated contract market” may trade both futures contracts and swap contracts, although there will be specific reporting rules for swap contracts. In order to properly limit section 1256 to futures contracts that trade on designated contract markets, Sec. 1.1256(b)-1(b) of the proposed regulations provides that a regulated futures contract is a section 1256 contract only if the contract is a futures contract that is not required to be reported as a swap under the Commodity Exchange Act (7 U.S.C. 1) (the CEA). The reporting provisions for swaps under the CEA will not be effective until the CFTC has published final rules implementing such provisions. It is anticipated that swap reporting rules will be in effect before these regulations are finalized. If, however, these proposed income tax regulations are finalized before the swap reporting provisions become effective, the Treasury Department and the IRS will evaluate whether the provisions of Sec. 1.1256(b)-1(b) need to be adjusted.

Questions have also been raised as to whether the requirement that a regulated futures contract be “traded on or subject to the rules of” a qualified board or exchange includes off-exchange transactions such as an exchange of a futures contract for a cash commodity, or an exchange of a futures contract for a swap, that are carried out subject to the rules of a CFTC designated contract market. The phrase “traded on or subject to the rules of” appears to have originated under the CEA. Section 4(a) of the CEA provides, in part, that it is unlawful to engage in any transaction in, or in connection with, a commodity futures contract unless such transaction is conducted on or subject to the rules of a board of trade which has been designated as a contract market and such contract is executed or consummated by or through a contract market. Section 5(d) of the CEA, as amended by section 735 of the Dodd-Frank Act, provides that the rules of a designated contract market may authorize, for bona fide business purposes, transfer trades or office trades, or an exchange of (i) Futures in connection with a cash commodity transaction, (ii) futures for cash commodities, or (iii) futures for swaps. As such, the Treasury Department and the IRS believe that a futures contract that results from one of these transactions is a regulated futures contract under section 1256(g)(1) because the contract is traded subject to the rules of a designated contract market.

#### D. Qualified Board or Exchange

Section 1256(g)(7)(C) provides that a qualified board or exchange includes any other exchange, board of trade, or other market which the Secretary determines has rules adequate to carry out the purposes of section 1256. Section 1.1256(g)-1(a) of the proposed regulations specifies that such determinations are only made through published guidance in the Federal Register or in the Internal Revenue Bulletin.

Since section 1256(g)(7) was adopted, the Treasury Department and the IRS have issued determinations for six entities, all of them foreign futures exchanges. See Rev. Rul. 2010-3 (2010-1 CB 272 (London International Financial Futures and Options Exchange)), Rev. Rul. 2009-24 (2009-2 CB 306 (ICE Futures Canada)), Rev. Rul. 2009-4 (2009-1 CB 408 (Dubai Mercantile Exchange)), Rev. Rul. 2007-26 (2007-1 CB 970 (ICE Futures)), Rev. Rul. 86-7 (1986-1 CB 295 (The Mercantile Division of the Montreal Exchange)), and Rev. Rul. 85-72 (1985-1 CB 286 (International Futures Exchange (Bermuda))). The IRS has followed a two step process for making each of the six qualified board or exchange determinations under section 1256(g)(7). See Sec. 601.601(d)(2)(ii)(b).

In the first step, the exchange submitted a private letter ruling to the IRS requesting a determination that the exchange is a qualified board or exchange within the meaning of section 1256(g)(7)(C). Once the IRS determined that the exchange had rules sufficient to carry out the purposes of section 1256, the Treasury Department and the IRS published a revenue ruling announcing that the named exchange was a qualified board or exchange. The revenue rulings apply to commodity futures contracts and futures contract options of the type described under the CEA that are entered into on the named exchange. The revenue ruling does not apply to contracts that are entered into on another exchange that is affiliated with the named exchange.

In determining whether a foreign exchange is a qualified board or exchange under section 1256(g)(7)(C), the Treasury Department and the IRS have looked to whether the exchange received a CFTC "direct access" no-action relief letter permitting the exchange to make its electronic trading and matching system available in the United States, notwithstanding that the exchange was not designated as a contract market pursuant to section 5 of the CEA. Section 738 of the Dodd-Frank Act, however, provides the CFTC with authority to adopt rules and regulations that require registration of a foreign board of trade that provides United States participants direct access to the foreign board of trade's electronic trading system. In formulating these rules and regulations, the CFTC is directed to consider whether comparable supervision and regulation exists in the foreign board of trade's home country. Pursuant to section 738, the CFTC has proposed a registration system to replace the direct access no-action letter process. Under the proposed registration system, a foreign board of trade operating pursuant to an existing direct access no-action relief letter must apply through a limited application process for an "Order of Registration" which will replace the foreign board of trade's existing direct access no-action letter. Many of the proposed requirements for and conditions applied to a foreign board of trade's registration will be based upon those applicable to the foreign board of trade's currently granted direct access no-action relief letter.

The IRS has conditioned a foreign exchange's qualified board or exchange status under section 1256(g)(7)(C) on the exchange continuing to satisfy all CFTC conditions necessary to retain its direct access no-action relief letter. Consequently, if the CFTC adopts the proposed registration system, an exchange that has previously received a qualified board or exchange determination under section 1256(g)(7)(C) must obtain a CFTC Order of Registration in order to maintain its qualified board or exchange status. The IRS will continue to evaluate the CFTC's rules in this regard to determine if any changes to the IRS's section 1256(g)(7)(C) guidance process are warranted.

## E. Definition and Scope of a Notional Principal Contract

### 1. Payments Under a Notional Principal Contract

In 1993, the IRS promulgated Sec. 1.446-3(c) which defines a notional principal contract as a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. Questions have arisen as to the proper interpretation of this requirement. Sections 1.446-3(c)(1)(i) and (ii) of the proposed regulations expressly provide that a notional principal contract requires one party to make two or more payments to a counterparty. For this purpose, the fixing of an amount is treated as a payment, even if the actual payment reflecting that amount is to be made at a later date. Thus, for example, a contract that provides for a settlement payment referenced to the appreciation or depreciation on a specified number of shares of common stock, adjusted for actual dividends paid during the term of the contract, is treated as a contract with more than one payment with respect to that leg of the contract.

### 2. Credit Default Swaps

In Notice 2004-52 (2004-2 CB 168), the Treasury Department and the IRS described four possible characterizations of a credit default swap. See Sec. 601.601(d)(2)(ii)(b). These proposed regulations resolve this uncertainty by adding credit default swaps to the list of swaps categorized as notional principal contracts governed by the rules of Sec. 1.446-3.

### 3. Weather-Related and Other Non-Financial Index Based Swaps

Since the time that the Sec. 1.446-3 regulations were promulgated, markets have developed for contracts based on non-financial indices. Many of these contracts are structured as swaps, and payments are calculated based on indices such as temperature, precipitation, snowfall, or frost. For example, payments made under a weather derivative may be based on heating degree days and cooling degree days. As a technical matter, a weather-related swap currently is not a notional principal contract because a weather index does not qualify as a "specified index" under Sec. 1.446-3(c)(2) of the current regulations, which generally require that such index be a financial index.

The Treasury Department and the IRS believe that swaps on non-financial indices should be treated as notional principal contracts. Accordingly, Sec. 1.446-3(c)(2)(ii) of the proposed regulations expands a specified index to include non-financial indices that are comprised of any objectively determinable information that is not within the control of any of the parties to the contract and is not unique to one of the parties' circumstances, and that cannot be reasonably expected to front-load or back-load payments accruing under the contract.

### 4. Excluded Contracts

Section 1.446-3(c)(1)(ii) currently provides that a contract described in section 1256(b) and a futures contract are not notional principal contracts. In order to remove the circularity that would otherwise exist between excluded contracts under Sec. 1.446-3(c)(1)(ii) and proposed Sec. 1.1256(b)-1, a contract described in section 1256(b) and a futures contract have been deleted from excluded contracts under proposed Sec. 1.446-3(c)(1)(iv).

### 5. Conforming Amendments

The definition of a notional principal contract in Sec. 1.446-3(c) of the proposed regulations is intended to be the operative definition for all Federal income tax purposes, except where a different or more limited definition is specifically prescribed. Thus, the regulations under sections 512, 863, 954, and 988 have been amended to reference the definition of a notional principal contract in Sec. 1.446-3(c).

Proposed Effective/Applicability Date

These regulations are proposed to apply to contracts entered into on or after the date the final regulations are published in the Federal Register.

### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to 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. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Comments and 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 IRS invite comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available at <http://www.regulations.gov> or upon request.

A public hearing has been scheduled for January 19, 2012, beginning at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments by December 15, 2011 and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by December 14, 2011. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### Drafting Information

The principal author of these proposed regulations is K. Scott Brown, Office of the Associate Chief Counsel (Financial Institutions and Products). 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 1.446-3 is amended by:

1. Revising the entries for the table of contents in Sec. 1.446-3(a) for paragraphs (c) and (j).
2. Revising paragraphs (c)(1), (c)(2), and (c)(3).
3. Adding and reserving paragraph (c)(5).
4. Adding paragraph (c)(6).
5. Adding two sentences to the end of paragraph (j).

The revisions and additions read as follows:

### Sec. 1.446-3 Notional principal contracts.

\* \* \* \* \*

(c) Definitions and scope.

(1) Notional principal contract.

(i) In general.

(ii) Payment defined.

(iii) Included contracts.

(A) Special rule for credit default swaps.

(B) Special rule for nonfunctional currency notional principal contracts.

(iv) Excluded contracts.

(v) Transactions within section 475.

(vi) Transactions within section 988.

(2) Specified index.

(i) Specified financial index.

(ii) Specified non-financial index.

(3) Notional principal amount.

(4) Special definitions.

(i) Related person and party to the contract.

(ii) Objective financial information.

(iii) Dealer in notional principal contracts.

(5) [Reserved]

(6) Examples.

\* \* \* \* \*

(j) Effective/applicability date.

\* \* \* \* \*

(c) Definitions and scope--(1) Notional principal contract--(i) In general. A notional principal contract is a financial instrument that requires one party to make two or more payments to the counterparty at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. An agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract because a taxpayer cannot enter into a contract with itself.

(ii) Payment defined. For purposes of paragraph (c)(1)(i) of this section, a payment includes an amount that is fixed on one date and paid or otherwise taken into account on a later date. Thus, for example, a contract that provides for a settlement payment referenced to the

appreciation or depreciation on a specified number of shares of common stock, adjusted for actual dividends paid during the term of the contract, is treated as a contract with more than one payment with respect to that leg of the contract. See Example 2 of this paragraph (c).

(iii) Included contracts. Notional principal contracts governed by this section include contracts commonly referred to as interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, credit default swaps, weather-related swaps, and similar agreements that satisfy the requirements of paragraph (c)(1)(i). A collar is not itself a notional principal contract, but a cap and a floor that comprise a collar may be treated as a single notional principal contract under paragraph (f)(2)(v)(C) of this section. A contract may be a notional principal contract governed by this section even though the term of the contract is subject to termination or extension. Each confirmation under a master agreement to enter into an agreement covered by this section is treated as a separate notional principal contract (or as more than one notional principal contract if the confirmation creates more than one notional principal contract). Notwithstanding the rule under paragraph (c)(3) of this section--

(A) Special rule for credit default swaps. A credit default swap contract that permits or requires the delivery of specified debt instruments in satisfaction of one leg of the contract is a notional principal contract if it otherwise satisfies the requirements of paragraph (c)(1)(i) of this section.

(B) Special rule for nonfunctional currency notional principal contracts. A notional principal contract that permits or requires the delivery of specified currency in satisfaction of one or both legs of the contract but that otherwise qualifies as a nonfunctional currency notional principal contract under Sec. 1.988-1(a)(2)(iii)(B) is a notional principal contract.

(iv) Excluded contracts. A forward contract, an option, and a guarantee are not notional principal contracts. An instrument or contract that constitutes indebtedness under general Federal income tax law is not a notional principal contract. An option or forward contract that entitles or obligates a person to enter into a notional principal contract is not a notional principal contract, but payments made under such an option or forward contract may be governed by paragraph (g)(3) of this section.

(v) Transactions within section 475. To the extent that the rules provided in paragraphs (e) and (f) of this section are inconsistent with the rules that apply to any notional principal contract that is governed by section 475 and the regulations thereunder, the rules of section 475 and the regulations thereunder govern.

(vi) Transactions within section 988. To the extent that the rules provided in this section are inconsistent with the rules that apply to any notional principal contract that is also a section 988 transaction or that is integrated with other property or debt pursuant to section 988(d), the rules of section 988 and the regulations thereunder govern. The rules of Sec. 1.446-3(g)(4) are not considered to be inconsistent with the rules of section 988. See Sec. 1.988-2(e)(3)(iv).

(2) Specified index. A specified index may be either a specified financial index or a specified non-financial index.

(i) Specified financial index. A specified financial index is--

(A) A fixed rate, price, or amount;

(B) A fixed rate, price, or amount applicable in one or more specified periods followed by one or more different fixed rates, prices, or amounts applicable in other periods;

(C) An index that is based on objective financial information (as defined in paragraph (c)(4)(ii) of this section); and

(D) An interest rate index that is regularly used in normal lending transactions between a party to the contract and unrelated persons.

(ii) Specified non-financial index. A specified non-financial index is any objectively determinable information that--

(A) Is not within the control of any of the parties to the contract and is not unique to one of the parties' circumstances;

(B) Is not financial information; and

(C) Cannot be reasonably expected to front-load or back-load payments accruing under the contract.

(3) Notional principal amount. For purposes of this section, a notional principal amount is any specified amount of money or property that, when multiplied by either a specified financial index or a specified non-financial index, measures a party's rights and obligations under the contract, but is not borrowed, loaned, or sold between the parties as part of the contract. The notional principal amount may vary over the term of the contract, provided that it is set in advance or varies based on objective financial information (as defined in paragraph (c)(4)(ii) of this section). If a notional principal contract references a notional principal amount that varies, or that references a different notional principal amount for each party, and a principal purpose for entering into the contract is to avoid the application of the rules in this section, the Commissioner may recharacterize the contract according to its substance, including by separating the contract into a series of notional principal contracts for purposes of applying the rules of this section or by treating the contract, in whole or in part, as a loan.

\* \* \* \* \*

(5) [Reserved]

(6) Examples. The following examples illustrate the application of paragraph (c) of this section.

Example 1. Forward rate agreement. (i) On January 1, 2012, A enters into a contract with unrelated counterparty B under which on December 31, 2013, A will pay or receive from B, as the case may be, an amount determined by subtracting 6% multiplied by a notional amount of \$10 million from 3 month LIBOR on December 31, 2013 multiplied by the same notional amount ((3 month LIBOR x \$10,000,000)-(6% x \$10,000,000)). The contract provides for no other payments.

(ii) Because this contract provides for a single net payment between A and B determined by interest rates in effect on the settlement date of the contract, the contract is not a notional principal contract defined in Sec. 1.446-3(c)(1)(i).

Example 2. Equity total return contract with dividend adjustments. (i) On January 1, 2012, A enters into a contract with unrelated counterparty B under which on December 31, 2013, A will receive from B an amount equal to the appreciation (if any) on a notional amount of 1 million shares of XYZ common stock, plus any dividends or other distributions that are paid on 1 million shares of XYZ common stock during the term of the contract. In return, on December 31, 2013 A will pay B an amount equal to any depreciation on 1 million shares of XYZ common stock, and an amount equal to 3 month LIBOR multiplied by the notional value of 1 million shares of XYZ stock on January 1, 2012 compounded over the term of the contract. All payments are netted such that A and B are only liable for the net payment due under the contract on December 31, 2013.

(ii) Because both legs of this contract provide for payments that become fixed during the term of the contract (the dividend payments and the LIBOR-based payments), each leg of the contract is treated as providing for more than one payment. In addition, since the indices referenced in the contract are specified indices described in paragraph (c)(2)(i) of this section, and the 1 million shares of XYZ common stock are a notional principal amount described in paragraph (c)(3) of this section, the contract is a notional principal contract defined in Sec. 1.446-3(c)(1)(i).

\* \* \* \* \*

(j) Effective/applicability date. \* \* \* The rules of paragraph (c) of this section apply to notional principal contracts entered into on or after the date of publication of a Treasury decision

adopting these rules as final regulations in the Federal Register. Section 1.446-3(c) as contained in 26 CFR part 1 revised April 1, 2011, continues to apply to notional principal contracts entered into before the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register.

Par. 3. Section 1.512(b)-(1) is amended by:

1. Revising paragraph (a)(1).
2. Adding two sentences to the end of paragraph (a)(3).

The revision and addition read as follows:

#### Sec. 1.512(b)-1 Modifications.

\* \* \* \* \*

(a) Certain Investment Income--(1) In general. Dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), annuities, income from notional principal contracts (as defined in Sec. 1.446-3(c)), other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner, and all deductions directly connected with any of the foregoing items of income shall be excluded in computing unrelated business taxable income.

\* \* \* \* \*

(3) \* \* \* The rules of paragraph (a)(1) of this section apply to notional principal contracts as defined in Sec. 1.446-3(c) that are entered into on or after the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register. Section 1.512(b)-1(a)(1) as contained in 26 CFR part 1 revised April 1, 2011, continues to apply to notional principal contracts entered into before the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register.

\* \* \* \* \*

Par. 4. Section 1.863-7 is amended by:

1. Revising the third sentence and removing the fourth sentence of paragraph (a)(1).
2. Adding two sentences to the end of paragraph (a)(2).

The revision and addition read as follows:

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

(a) Scope--(1) Introduction. \* \* \* Notional principal contract income is income attributable to a notional principal contract as defined in Sec. 1.446-3(c). \* \* \*

(2) \* \* \* The rules of this section apply to notional principal contracts as defined in Sec. 1.446-3(c) that are entered into on or after the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register. Section 1.863-7 as contained in 26 CFR part 1 revised April 1, 2011, continues to apply to notional principal contracts entered into before the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register.

\* \* \* \* \*

Par. 5. Section 1.954-2 is amended by:

1. Revising paragraph (h)(3)(i).
2. Adding paragraph (h)(3)(iii).

The revision and addition read as follows:

Sec. 1.954-2 Foreign personal holding company income.

\* \* \* \* \*

(3) Notional principal contracts--(i) In general. Income equivalent to interest includes income from notional principal contracts (as defined in Sec. 1.446-3(c)) denominated in the functional currency of the taxpayer (or a qualified business unit of the taxpayer, as defined in section 989(a)), the value of which is determined solely by reference to interest rates or interest rate indices, to the extent that the income from such transactions accrues on or after August 14, 1989.

\* \* \* \* \*

(iii) Effective/applicability date. The rules of paragraph (h)(3) of this section apply to notional principal contracts as defined in Sec. 1.446-3(c) that are entered into on or after the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register. Section 1.954-2(h)(3) as contained in 26 CFR part 1 revised April 1, 2011, continues to apply to notional principal contracts entered into before the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register.

\* \* \* \* \*

Par. 6. Section 1.988-1 is amended by:

1. Revising paragraph (a)(2)(iii)(B)(2).
2. Adding two sentences to the end of paragraph (a)(2)(iii)(C).

The revision and addition read as follows:

Sec. 1.988-1 Certain definitions and special rules.

(a) \* \* \*

(2) \* \* \*

(iii) \* \* \*

(B) \* \* \*

(2) Definition of notional principal contract. Generally, the term "notional principal contract" means a contract defined in Sec. 1.446-3(c). However, a "notional principal contract" shall only be considered as described in paragraph (a)(2)(iii)(B)(1) of this section if the underlying property to which the instrument ultimately relates is money (for example, functional currency), nonfunctional currency, or property the value of which is determined by reference to an interest rate. Thus, the term "notional principal contract" includes a currency swap as defined in Sec. 1.988-2(e)(2)(ii), but does not include a swap referenced to a commodity or equity index.

(C) \* \* \* The rules of this paragraph (a)(2)(iii) apply to notional principal contracts as defined in Sec. 1.446-3(c) that are entered into on or after the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register. Section 1.988-1(a)(2)(iii) as contained in 26 CFR part 1 revised April 1, 2011, continues to apply to notional principal contracts entered into before the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register.

\* \* \* \* \*

Par. 7. Section 1.1256(b)-1 is added to read as follows:

Sec. 1.1256(b)-1 Section 1256 contract defined.

(a) General rule. A section 1256 contract does not include any contract, or option on such contract, that is a notional principal contract as defined in Sec. 1.446-3(c). A contract that is defined as both a notional principal contract in Sec. 1.446-3(c) and as a section 1256 contract in section 1256(b)(1) is treated as a notional principal contract and not as a section 1256 contract.

(b) Regulated futures contract. A regulated futures contract is a section 1256 contract only if the contract is a futures contract--

(1) With respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market;

(2) That is traded on or subject to the rules of a qualified board or exchange; and

(3) That is not required to be reported as a swap under the Commodity Exchange Act.

(c) Effective/applicability date. The rules of this section apply to contracts entered into on or after the date the final regulations are published in the Federal Register.

Par. 8. Section 1.1256(g)-1 is added to read as follows:

Sec. 1.1256(g)-1 Qualified board or exchange defined.

(a) General rule. A qualified board or exchange means a national securities exchange registered with the Securities Exchange Commission, a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, or any other exchange, board of trade, or other market for which the Secretary determines in published guidance in the Federal Register or in the Internal Revenue Bulletin (see Sec. 601.601(d)(2)(ii) of this chapter) that such market has rules adequate to carry out the purposes of section 1256.

(b) Effective/applicability date. The rule of this section applies to taxable years ending on or after the date the final regulations are published in the Federal Register.

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