

need not include the recipient's signature. Electronic mail receipts shall also include the e-mail address to which notice was delivered, but need not include the recipient's signature. An applicant may rely on another form of documentation only if FDA has agreed to such documentation in advance.

* * * * *

4. Section 314.95 is amended by revising the introductory text of paragraph (a) and paragraph (e) and adding paragraph (c)(8) to read as follows:

§ 314.95 Notice of certification of invalidity or noninfringement of a patent.

(a) *Notice of certification.* For each patent that claims the listed drug or that claims a use for such listed drug for which the applicant is seeking approval and that the applicant certifies under § 314.94(a)(12) is invalid, unenforceable, or will not be infringed, the applicant shall give notice of such certification by mail or personal delivery to and shall obtain verification of receipt from each of the following persons: * * *

* * * * *

(c) * * *

(8) The envelope, where applicable, and cover sheet of the notice shall be clearly labeled in 14 point or larger, bold, all capitals type with the words "PATENT CERTIFICATION." E-mail notices shall state "PATENT CERTIFICATION" as the subject line and as the first line of text of the e-mail message.

* * * * *

(e) *Documentation of receipt of notice.* The applicant shall amend its abbreviated application to document receipt of the notice required under paragraph (a) of this section by each person provided the notice. The applicant shall include a copy of the return receipt or other similar evidence of the date the notification was received. FDA will accept as adequate documentation of the date of receipt a return receipt from registered or certified mail, a letter acknowledging receipt by the person provided the notice, or a verification of receipt that contains the date notice was delivered, the address to which notice was delivered, and the signature of the recipient. Electronic signatures and electronic records shall comply with the provisions of 21 CFR part 11. Facsimile receipts shall also include the telephone number to which notice was faxed, but need not include the recipient's signature. Electronic mail receipts shall also include the e-mail address to which notice was delivered, but need not include the recipient's signature. An

applicant may rely on another form of documentation only if FDA has agreed to such documentation in advance.

* * * * *

Dated: February 26, 1998.

William B. Schultz,

Deputy Commissioner for Policy.

[FR Doc. 98-5800 Filed 3-5-98; 8:45 am]

BILLING CODE 4160-01-F

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-208299-90]

RIN 1545-AP01

Allocation and Sourcing of Income and Deductions Among Taxpayers Engaged in a Global Dealing Operation

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed rules for the allocation among controlled taxpayers and sourcing of income, deductions, gains and losses from a global dealing operation; rules applying these allocation and sourcing rules to foreign currency transactions and to foreign corporations engaged in a U.S. trade or business; and rules concerning the mark-to-market treatment resulting from hedging activities of a global dealing operation. These proposed rules affect foreign and domestic persons that are participants in such operations either directly or indirectly through subsidiaries or partnerships. These proposed rules are necessary to enable participants in a global dealing operation to determine their arm's length contribution to a global dealing operation. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by June 4, 1998. Outlines of oral comments to be discussed at the public hearing scheduled for July 9, 1998, must be received by June 18, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-208299-90), 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-208299-90), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue,

N.W., Washington, D.C. 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:

Concerning the regulations in general, Ginny Chung of the Office of Associate Chief Counsel (International), (202) 622-3870; concerning the mark-to-market treatment of global dealing operations, Richard Hoge or JoLynn Ricks of the Office of Assistant Chief Counsel (Financial Institutions & Products), (202) 622-3920; concerning submissions and the hearing, Michael Slaughter, (202) 622-7190 (not toll-free numbers).

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 Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance officer, T:FS:FP, Washington, DC 20224. Comments on the collections of information should be received by May 5, 1998.

Comments are specifically requested concerning: Whether the proposed collections of information are 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 collections of information (see below);

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 these proposed regulations are in §§ 1.475(g)-2(b), 1.482-8(b)(3), 1.482-8(c)(3), 1.482-8(d)(3), 1.482-8(e)(5), 1.482-8(e)(6), and 1.863-3(h). The information is required to determine an arm's length price. The collections of information are mandatory. The likely recordkeepers are business or other for-profit institutions.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information 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 tax return information are confidential, as required by 26 U.S.C. 6103.

Estimated total annual recordkeeping burden: 20,000 hours. Estimated average annual burden per recordkeeper is 40 hours. Estimated number of recordkeepers: 500.

Background

In 1990, the IRS issued Announcement 90-106, 1990-38 IRB 29, requesting comments on how the regulations under sections 482, 864 and other sections of the Internal Revenue Code could be improved to address the taxation issues raised by global trading of financial instruments. Section 482 concerns the allocation of income, deductions, credits and allowances among related parties. Section 864 provides rules for determining the income of a foreign person that is "effectively connected" with the conduct of a U.S. trade or business and therefore can be taxed on a net income basis in the United States. Provisions under sections 864(c)(2) and (3) provide rules for determining when U.S. source income is effectively connected income (ECI); section 864(c)(4) provides rules for determining when foreign source income is ECI.

The rules for determining the source of income generally are in sections 861, 862, 863 and 865, and the regulations promulgated under those sections. Section 1.863-7 provides a special rule for income from notional principal contracts, under which such income will be treated as U.S.-source ECI if it arises from the conduct of a U.S. trade or business under principles similar to those that apply under section 864(c)(2). An identical rule applies for determining U.S. source ECI under § 1.988-4(c) from foreign exchange gain

or loss from certain transactions denominated in a foreign currency.

Because no regulations were issued in response to the comments that were received after Announcement 90-106, there remain a number of uncertainties regarding the manner in which the existing regulations described above apply to financial institutions that deal in financial instruments through one or more entities or trading locations. Many financial institutions have sought to resolve these problems by negotiating advance pricing agreements (APAs) with the IRS. In 1994, the IRS published Notice 94-40, 1994-1 CB 351, which provided a generic description of the IRS's experience with global dealing operations conducted in a functionally fully integrated manner. Notice 94-40 specified that it was not intended to prescribe rules for future APAs or for taxpayers that did not enter into APAs. Moreover, Notice 94-40 provided no guidance of any kind for financial institutions that do not conduct their global dealing operations in a functionally fully integrated manner.

Explanation of Provisions

1. Introduction

This document contains proposed regulations relating to the determination of an arm's length allocation of income among participants engaged in a global dealing operation. For purposes of these regulations, the terms "global dealing operation" and "participant" are specifically defined. The purpose of these regulations is to provide guidance on applying the arm's length principle to transactions between participants in a global dealing operation. The general rules in the final regulations under section 482 that provide the best method rule, comparability analysis, and the arm's length range are generally adopted with some modifications to conform these principles to the global dealing environment. In addition, the proposed regulations contain new specified methods with respect to global dealing operations that replace the specified methods in §§ 1.482-3 through 1.482-6.

This document also contains proposed regulations addressing the source of income earned in a global dealing operation and the circumstances under which such income is effectively connected to a foreign corporation's U.S. trade or business. The regulations proposed under section 863 generally source income earned in a global dealing operation by reference to the residence of the participant. For these purposes, residence is defined under section 988(a)(3)(B) such that global

dealing income may be sourced between separate qualified business units (QBUs) of a single taxpayer or among separate taxpayers who are participants, as the case may be. Exceptions to this general rule are discussed in further detail below.

Proposed amendments to the regulations under section 864 provide that the principles of the proposed section 482 regulations may be applied to determine the amount of income, gain or loss from a foreign corporation's global dealing operation that is effectively connected to a U.S. trade or business of a participant. Similar rules apply to foreign currency transactions that are part of a global dealing operation.

The combination of these allocation, sourcing, and effectively connected income rules is intended to enable taxpayers to establish and recognize on an arm's length basis the contributions provided by separate QBUs to a global dealing operation.

This document also contains proposed regulations under section 475 to coordinate the accounting rules governing the timing of income with the allocation, sourcing, and effectively connected income rules proposed in this document and discussed above.

2. Explanation of Specific Provisions

A. Section 1.482-1(a)(1)

Section 1.482-1(a)(1) has been amended to include expressly transactions undertaken in the course of a global dealing operation between controlled taxpayers within the scope of transactions covered by section 482. The purpose of this amendment is to clarify that the principles of section 482 apply to evaluate whether global dealing transactions entered into between controlled taxpayers are at arm's length.

B. Section 1.482-8(a)—General Requirements

Section 1.482-8(a)(1) lists specified methods that may be used to determine if global dealing transactions entered into between controlled taxpayers are at arm's length. The enumerated methods must be applied in accordance with all of the provisions of § 1.482-1, including the best method rule of § 1.482-1(c), the comparability analysis of § 1.482-1(d), and the arm's length range rule of § 1.482-1(e). The section further requires that any modifications or supplemental considerations applicable to a global dealing operation set forth in § 1.482-8(a)(3) be taken into account when applying any of the transfer pricing methods. Specific modifications to the factors for determining

comparability and the arm's length rule are provided in § 1.482-8(a)(3). These modifications and special considerations are discussed in more detail under their respective headings below.

C. Section 1.482-8(a)(2)—Definitions Applicable to a Global Dealing Operation

Section 1.482-8(a)(2) defines "global dealing operation," "participant," "regular dealer in securities," and other terms that apply for purposes of these regulations. These definitions supplement the general definitions provided in § 1.482-1(i).

The rules of § 1.482-8 apply only to a global dealing operation. A "global dealing operation" consists of the execution of customer transactions (including marketing, sales, pricing and risk management activities) in a particular financial product or line of financial products, in multiple tax jurisdictions and/or through multiple participants. The taking of proprietary positions is not included within the definition of a global dealing operation unless the proprietary positions are entered into by a regular dealer in securities in connection with its activities as such a dealer. Thus, a hedge fund that does not have customers is not covered by these regulations. Positions held in inventory by a regular dealer in securities, however, are covered by these regulations even if the positions are unhedged because the dealer is taking a view as to future market changes.

Similarly, lending activities are not included within the definition of a global dealing operation. However, if a person makes a market in, by buying and selling, asset-backed securities, the income from that activity may be covered by these regulations, regardless of whether the dealer was a party to the loans backing the securities. Therefore, income earned from such lending activities or from securities held for investment is not income from a global dealing operation and is not governed by this section. A security may be held for investment for purposes of this section even though it is not identified as held for investment under section 475.

Activities unrelated to the conduct of a global dealing operation are not covered by these regulations, even if they are accounted for on a mark-to-market basis. Accordingly, income from proprietary trading that is not undertaken in connection with a global dealing operation, and other financial transactions that are not entered into in a dealing capacity are not covered by

these proposed regulations. The regulations require that participants engaged in dealing and nondealing activities and/or multiple dealing activities segregate income and expense attributable to each separate dealing operation so that the best method may be used to evaluate whether controlled transactions entered into in connection with a particular dealing activity are priced at arm's length. The regulations also require that taxpayers segregate their dealer activities from their lending, proprietary trading or other investment activities not entered into in connection with a global dealing operation. Comments are solicited on whether the proposed regulations issued under section 475 in this notice of proposed rulemaking are sufficient to facilitate identification of the amount of income that should be subject to allocation under the global dealing regulations.

The term *participant* is defined as a controlled taxpayer that is either a regular dealer in securities within the meaning of § 1.482-8(a)(2)(iii), or a member of a group of controlled taxpayers which includes a regular dealer in securities, so long as that member conducts one or more activities related to the activities of such dealer. For these purposes, such related activities are the marketing, sales, pricing, and risk management activities necessary to the definition of a global dealing operation. Additionally, brokering is a related activity that may give rise to participant status. Related activities do not include credit analysis, accounting services, back office services, or the provision of a guarantee of one or more transactions entered into by a regular dealer in securities or other participant. This definition is significant because the transfer pricing methods contained in this section can only be used by participants, and only to evaluate whether compensation attributable to a regular dealer in securities or a marketing, sales, pricing, risk management or brokering function is at arm's length. Whether the compensation paid for other functions performed in the course of a global dealing operation (including certain services and development of intangibles) is at arm's length is determined under the appropriate section 482 regulations applicable to those transactions.

The definition of a global dealing operation does not require that the global dealing operation be conducted around the world or on a twenty-four hour basis. These regulations will apply if the controlled taxpayers, or QBUs of a single taxpayer, operate in the aggregate in more than one tax

jurisdiction. It is not necessary, however, for the participants to conduct the global dealing operation in more than one tax jurisdiction. For example, a participant that is resident in one tax jurisdiction may conduct its participant activities in the global dealing operation through a trade or business in another jurisdiction that is the same jurisdiction where the dealer activity of a separate controlled taxpayer takes place. In this situation, the rules of this section apply to determine the allocation of income, gain or loss between the two controlled taxpayers even if all of the income, gain or loss is allocable within the same tax jurisdiction.

The term *regular dealer in securities* is specifically defined in this regulation consistently with the definition of a regular dealer under § 1.954-2(a)(4)(iv). Under these proposed regulations, a dealer in physical securities or currencies is a regular dealer in securities if it regularly and actively offers to, and in fact does, purchase securities or currencies from and sell securities or currencies to customers who are not controlled taxpayers in the ordinary course of a trade or business. In addition, a dealer in derivatives is a regular dealer in securities if it regularly and actively offers to, and in fact does, enter into, assume, offset, assign or otherwise terminate positions in securities with customers who are not controlled entities in the ordinary course of a trade or business. The IRS solicits comments on whether these regulations should be extended to cover dealers in commodities and/or persons trading for their own account that are not dealers.

D. Best Method and Comparability

Consistent with the general principles of section 482, the best method rule applies to evaluate the most appropriate method for determining whether the controlled transactions are priced at arm's length. New specified methods which replace the specified methods of §§ 1.482-2 through 1.482-6 for a global dealing operation are set forth in §§ 1.482-8(b) through 1.482-8(f). The comparable profits method of § 1.482-5 has been excluded as a specified method for a global dealing operation because of the high variability in profits from company to company and year to year due to differences in business strategies and fluctuations in the financial markets.

The proposed regulations do not apply specific methods to certain trading models, such as those commonly referred to in the financial services industry as "separate enterprise," "natural home,"

“centralized product management,” or “integrated trading.” Rather, the proposed regulations adopt the best method rule of § 1.482-1(c) to determine the most appropriate transfer pricing methodology, taking into account all of the facts and circumstances of a particular taxpayer’s trading structure. Consistent with the best method rule, there is no priority of methods.

Application of the best method rule will depend on the structure and organization of the individual taxpayer’s global dealing operation and the nature of the transaction at issue. Where a taxpayer is engaged in more than one global dealing operation, it will be necessary to segregate each activity and determine on a transaction-by-transaction basis within each activity which method provides the most reliable measure of an arm’s length price. It may be appropriate to apply the same method to multiple transactions of the same type within a single business activity entered into as part of a global dealing operation. For example, if a taxpayer operates its global dealing activity in notional principal contracts differently than its foreign exchange trading activity, then the income from notional principal contracts may be allocated using a different methodology than the income from foreign exchange trading. Moreover, the best method rule may require that different methods be used to determine whether different controlled transactions are priced at arm’s length even within the same product line. For example, one method may be the most appropriate to determine if a controlled transaction between a global dealing operation and another business activity is at arm’s length, while a different method may be the most appropriate to determine if the allocation of income and expenses among participants in a global dealing operation is at arm’s length.

Section 1.482-8(a)(3) reiterates that the principle of comparability in § 1.482-1(d) applies to transactions entered into by a global dealing operation. The comparability factors provided in § 1.482-8(a)(3) (functional analysis, risk, and economic conditions), however, must be applied in place of the comparability factors discussed in § 1.482-1(d)(3). The comparability factors for contractual terms in § 1.482-8(a)(3) supplement the comparability factors for contractual terms in § 1.482-1(d)(3)(ii). The comparability factors in this section have been included to provide guidance on the factors that may be most relevant in assessing comparability in the context of a global dealing operation.

E. Arm’s Length Range

In determining the arm’s length range, § 1.482-1(e) will apply except as modified by these proposed regulations. In determining the reliability of an arm’s length range, the IRS believes that it is necessary to consider the fact that the market for financial products is highly volatile and participants in a global dealing operation frequently earn only thin profit margins. The reliability of using a statistical range in establishing a comparable price of a financial product in a global dealing operation is based on facts and circumstances. In a global dealing operation, close proximity in time between a controlled transaction and an uncontrolled transaction may be a relevant factor in determining the reliability of the uncontrolled transaction as a measure of the arm’s length price. The relevant time period will depend on the price volatility of the particular product.

The district director may, notwithstanding § 1.482-1(e)(1), adjust a taxpayer’s results under a method applied on a transaction-by-transaction basis if a valid statistical analysis demonstrates that the taxpayer’s controlled prices, when analyzed on an aggregate basis, provide results that are not arm’s length. See § 1.482-1(f)(2)(iv). This may occur, for example, when there is a pattern of prices in controlled transactions that are higher or lower than the prices of comparable uncontrolled transactions.

Comments are solicited on the types of analyses and factors that may be relevant for pricing controlled financial transactions in a global dealing operation. Section 1.482-1(e) continues to apply in its entirety to transactions among participants that are common to businesses other than a global dealing operation. In this regard, the existing rules continue to apply to pricing of certain services from a participant to a regular dealer in securities other than services that give rise to participant status.

F. Comparable Uncontrolled Financial Transaction Method

The comparable uncontrolled financial transaction (CUFT) method is set forth in § 1.482-8(b). The CUFT method evaluates whether controlled transactions satisfy the arm’s length standard by comparing the price of a controlled financial transaction with the price of a comparable uncontrolled financial transaction. Similarity in the contractual terms and risks assumed in entering into the financial transaction are the most important comparability factors under this method.

Ordinarily, in global dealing operations, proprietary pricing models are used to calculate a financial product’s price based upon market data, such as interest rates, currency rates, and market risks. The regulations contemplate that indirect evidence of the price of a CUFT may be derived from a proprietary pricing model if the data used in the model is widely and routinely used in the ordinary course of the taxpayer’s business to price uncontrolled transactions, and adjustments are made to the amount charged to reflect differences in the factors that affect the price to which uncontrolled taxpayers would agree. In addition, the proprietary pricing model must be used in the same manner to price transactions with controlled and uncontrolled parties. If a taxpayer uses its internal pricing model as evidence of a CUFT, it must, upon request, furnish the pricing model to the district director in order to substantiate its use.

G. Gross Margin Method

The gross margin method is set forth in § 1.482-8(c) and should be considered in situations where a taxpayer performs only a routine marketing or sales function as part of a global dealing operation. Frequently, taxpayers that perform the sales function in these circumstances participate in the dealing of a variety of, rather than solely identical, financial products. In such a case, the variety of financial products sold within a relevant time period may limit the availability of comparable uncontrolled financial transactions. Where the taxpayer has performed a similar function for a variety of products, however, the gross margin method can be used to determine if controlled transactions are priced at arm’s length by reference to the amount earned by the taxpayer for performing similar functions with respect to uncontrolled transactions.

The gross margin method determines if the gross profit realized on sales of financial products acquired from controlled parties is at arm’s length by comparing that profit to the gross profit earned on uncontrolled transactions. Since comparability under this method depends on the similarity of functions performed and risks assumed, adjustments must be made for differences between the functions performed in the disposition of financial products acquired in controlled transactions and the functions performed in the disposition of financial products acquired in uncontrolled transactions. Although close product similarity will tend to improve the

reliability of the gross margin method, the reliability of this method is not as dependent on product similarity as the CUFT method.

Participants in a global dealing operation may act simply as brokers, or they may participate in structuring complex products. As the role of the participant exceeds the brokerage function, it becomes more difficult to find comparable functions because the contributions made in structuring one complex financial product are not likely to be comparable to the contributions made in structuring a different complex financial product. Accordingly, the regulations provide that the reliability of this method is decreased where a participant is substantially involved in developing a financial product or in tailoring the product to the unique requirements of a customer prior to resale.

H. Gross Markup Method

Like the gross margin method, the gross markup method set forth in § 1.482-8(d) should generally be considered in situations where a taxpayer performs only a routine marketing or sales function as part of a global dealing operation, and, as is often the case, handles a variety of financial products within a relevant time period. The gross markup method is generally appropriate in cases where the taxpayer performs a routine sales function in buying a financial product from an uncontrolled party and reselling or transferring the product to a controlled party.

The gross markup method determines if the gross profit earned on the purchase of financial products from uncontrolled parties and sold to controlled taxpayers is at arm's length by comparing that profit to the gross profit earned on uncontrolled transactions. Like the gross margin method, comparability under this method depends on the similarity of the functions performed and risks assumed in the controlled and uncontrolled transactions. Accordingly, adjustments should be made for differences between the functions performed in the sale or transfer of financial products to controlled parties, and the functions performed with respect to the sale or transfer of financial products to uncontrolled parties. Although close product similarity will tend to improve the reliability of the gross markup method, the reliability of this method is not as dependent on product similarity as the CUFT method.

As in the gross margin method, the regulations provide that the reliability of this method generally is decreased

where a participant is substantially involved in developing a financial product or in tailoring the product to the unique requirements of a customer prior to resale.

I. Profit Split Methods

New profit split methods are proposed for global dealing participants under § 1.482-8(e). Global dealing by its nature involves a certain degree of integration among the participants in the global dealing operation. The structure of some global dealing operations may make it difficult to apply a traditional transactional method to determine if income is allocated among participants on an arm's length basis. Two profit split methods, the total profit split method and the residual profit split method, have been included as specified methods for determining if global dealing income is allocated at arm's length.

Profit split methods may be used to evaluate if the allocation of operating profit from a global dealing operation compensates the participants at arm's length for their contribution by evaluating if the allocation is one which uncontrolled parties would agree to. Accordingly, the reliability of this method is dependent upon clear identification of the respective contributions of each participant to the global dealing operation.

In general, the profit split methods must be based on objective market benchmarks that provide a high degree of reliability, i.e., comparable arrangements between unrelated parties that allocate profits in the same manner and on the same basis. Even if such comparable uncontrolled transactions are not available, however, the taxpayer may be able to demonstrate that a total profit split provides arm's length results that reflect the economic value of the contribution of each participant, by reference to other objective factors that provide reliability due to their arm's length nature. For example, an allocation of income based on trader bonuses may be reliable, under the particular facts and circumstances of a given case, if the taxpayer can demonstrate that such bonuses are based on the value added by the individual traders. By contrast, an allocation based on headcount or gross expenses may be unreliable, because the respective participants might, for example, have large differences in efficiency or cost control practices, which would tend to make such factors poor reflections of the economic value of the functions contributed by each participant.

The proposed regulations define gross profit as gross income earned by the global dealing operation. Operating expenses are those not applicable to the determination of gross income earned by the global dealing operation. The operating expenses are global expenses of the global dealing operation and are subtracted from gross profit to determine the operating profit. Taxpayers may need to allocate operating expenses that relate to more than one global dealing activity.

The regulations state that in appropriate circumstances a multi-factor formula may be used to determine whether an allocation is at arm's length. Use of a multi-factor formula is permitted so long as the formula allocates the operating profit or loss based upon the factors that uncontrolled taxpayers would consider. The regulations do not prescribe specific factors to be used in the formula since the appropriateness of any one factor will depend on all the facts and circumstances associated with the global dealing operation. However, the regulations require that the multi-factor formula take into account all of the functions performed and risks assumed by a participant, and attribute the appropriate amount of income or loss to each function. The IRS also solicits comments concerning which factors may be appropriate (for example, initial net present value of derivatives contracts) and the circumstances under which specific factors may be appropriately applied.

The purpose of the factors is to measure the relative value contributed by each participant. Thus, adjustments must be made for any circumstances other than the relative value contributed by a participant that influence the amount of a factor so that the factor does not allocate income to a participant based on circumstances that are not relevant to the value of the function or activity being measured. For example, if trader compensation is used to allocate income among participants, and the traders in two different jurisdictions would be paid different amounts (for example, due to cost of living differences) to contribute the same value, adjustments should be made for the difference so that the factors accurately measure the value contributed by the trading function. The IRS solicits comments regarding the types of adjustments that should be made, how to make such adjustments, and the need for further guidance on this point.

The total profit split method entails a one step process whereby the operating profit is allocated among the

participants based on their relative contributions to the profitability of the global dealing operation. No distinction is made between routine and nonroutine contributions. The total profit split method may be useful to allocate income earned by a highly integrated global dealing operation where all routine and nonroutine dealer functions are performed by each participant in each location. Accordingly, total profit or loss of the global dealing operation may be allocated among various jurisdictions based on the relative performance of equivalent functions in each jurisdiction.

The residual profit split method entails a two step process. In the first step, the routine functions are compensated with a market return based upon the best transfer pricing method applicable to that transaction. Routine functions may include, but are not limited to, functions that would not give rise to participant status and which should be evaluated under §§ 1.482–3 through 1.482–6. After compensating the routine functions, the remaining operating profit (the “residual profit”) is allocated among the participants based upon their respective nonroutine contributions.

It should be noted that, while in appropriate cases a profit split method may be used to determine if a participant is compensated at arm's length, use of the profit split method does not change the contractual relationship between participants, nor does it affect the character of intercompany payments. For example, if a controlled taxpayer provides solely trading services to a global dealing operation in a particular jurisdiction, any payment it receives as compensation for services retains its character as payment for services and, under the regulations, is not converted into a pro rata share of each item of gross income earned by the global dealing operation.

J. Unspecified Methods

Consistent with the principles underlying the best method rule, the regulations provide the option to use an unspecified method if it is determined to be the best method. The IRS solicits comments on the extent to which the variety of methods on which specific guidance has been provided is adequate.

Guidance on the use of a comparable profits method has specifically not been included as a specified method in the proposed regulations because use of that method depends on the existence of arrangements between uncontrolled taxpayers that perform comparable functions and assume comparable risks.

Global dealing frequently involves the use of unique intangibles such as trader know-how. Additionally, anticipated profit is often influenced by the amount of risk a participant is willing to bear. Accordingly, the IRS believes it is unlikely that the comparability of these important functions can be measured and adjusted for accurately in a global dealing operation.

K. Source of Global Dealing Income

Under current final regulations in § 1.863–7(a), all of the income attributable to a notional principal contract is sourced by reference to the taxpayer's residence. Exceptions are provided for effectively connected notional principal contract income, and for income earned by a foreign QBU of a U.S. resident taxpayer if the notional principal contract is properly reflected on the books of the foreign QBU. Attribution of all of the income from a notional principal contract to a single location has generally been referred to as the “all or nothing” rule. The current final regulations do not provide for multi-location sourcing of notional principal contract income among the QBUs that have participated in the acquisition or risk management of a notional principal contract and therefore do not recognize that significant activities, including structuring or risk managing derivatives, often occur through QBUs in more than one jurisdiction.

Recognizing the need for multi-location sourcing of income earned in a global dealing operation, the proposed regulations provide a new rule under § 1.863–3 which sources income from a global dealing operation in the same manner as the income would be allocated under § 1.482–8 if each QBU were a separate entity. However, the rules must be applied differently to take into account the economic differences between acting through a single legal entity and through separate legal entities.

Accordingly, income from a single transaction may be split-sourced to more than one location, so long as the allocation methodology satisfies the arm's length standard. The all or nothing rule of § 1.863–7(a) continues to apply to notional principal contract income attributable to activities not related to a global dealing operation. Corresponding changes have been made in proposed § 1.988–4(h) to exclude exchange gain or loss derived in the conduct of a global dealing operation from the general source rules in § 1.988–4 (b) and (c).

These special source rules apply only with respect to participants that perform

a dealing, marketing, sales, pricing, risk management or brokering function. Moreover, these rules do not apply to income, such as fees for services, for which a specific source rule is provided in section 861, 862 or 865 of the Code. Accordingly, if a controlled taxpayer provides back office services, the amount and source of an intercompany payment for such services is determined under existing transfer pricing and sourcing rules applicable to those services without regard to whether the controlled taxpayer is also a participant in a global dealing operation.

If an entity directly bears the risk assumed by the global dealing operation, it should be compensated for that function. In providing, however, that the source (and effectively connected status) of global dealing income is determined by reference to where the dealing, marketing, sales, pricing, risk management or brokering function that gave rise to the income occurred, the regulations effectively provide that compensation for risk bearing should be sourced by reference to where the capital is employed by traders, marketers and salespeople, rather than the residence of the capital provider. This principle applies where a taxpayer directly bears risk arising from the conduct of a global dealing operation, such as when it acts as a counterparty without performing other global dealing functions. A special rule provides that the activities of a dependent agent may give rise to participant status through a deemed QBU that performs its participant functions in the same location where the dependent agent performs its participant functions. The deemed QBU may be created without regard to the books and records requirement of § 1.989–1(b).

As indicated, accounting, back office, credit analysis, and general supervision and policy control functions do not give rise to participant status in a global dealing operation but are services that should be remunerated and sourced separately under existing rules. This principle also applies where a taxpayer bears risk indirectly, such as through the extension of a guarantee. Accordingly, the sourcing rule of § 1.863–3(h) does not apply to interest, dividend, or guarantee fee income received by an owner or guarantor of a global dealing operation that is conducted by another controlled taxpayer. The source of interest, dividend and guarantee fee income, substitute interest and substitute dividend payments sourced under §§ 1.861–2(a)(7) and 1.861–3(a)(6), and other income sourced by section 861,

862 or 865 continues to be governed by the source rules applicable to those transactions.

The proposed regulations provide, consistent with U.S. tax principles, that an agreement between two QBUs of a single taxpayer does not give rise to a transaction because a taxpayer cannot enter into nor profit from a "transaction" with itself. See, e.g., § 1.446-3(c)(1). The IRS believes, however, that these agreements between QBUs of a single taxpayer may provide evidence of how income from the taxpayer's transactions with third parties should be allocated among QBUs. It is a common practice for taxpayers to allocate income or loss from transactions with third parties among QBUs for internal control and risk management purposes. Accordingly, the proposed regulations specifically provide that such allocations may be used to source income to the same extent and in the same manner as they may be used to allocate income between related persons. Conversely, such transactions may not be used to the extent they do not provide an arm's length result.

L. Determination of Global Dealing Income Effectively Connected With a U.S. Business

After determining the source of income, it is necessary to determine the extent to which such income is ECI. Under current law, the general rule is that all of the income, gain or loss from a global dealing operation is effectively connected with a U.S. trade or business if the U.S. trade or business materially participates in the acquisition of the asset that gives rise to the income, gain or loss, or property is held for use in the active conduct of a U.S. trade or business, or the business activities conducted by the U.S. trade or business are a material factor in the realization of income, gain or loss. As noted above, the current final regulations do not permit the attribution of income, gain or loss from a global dealing operation that is allocated and sourced to a U.S. trade or business under § 1.863-3(h) shall be effectively connected. In this regard, an asset used in a global dealing operation is treated as an asset used in a U.S. trade or business to the extent that an allocation is made to a U.S. QBU. Similarly, the U.S. trade or business is also treated as a material factor in the realization of income, gain or loss for which an allocation is made to a U.S. QBU. A special rule for U.S. source interest and dividend income, including substitute interest and substitute dividends, earned by a foreign banking or similar financial institution in a

global dealing operation treats such income as attributable to a U.S. trade or business to the extent such income would be sourced to the United States under § 1.863-3(h). Any foreign source income allocated to the United States under the principles of § 1.863-3(h) is also treated as attributable to the U.S. trade or business.

The proposed regulations also limit an entity's effectively connected income from a global dealing operation to that portion of an item of income, gain or loss that would be sourced to the U.S. trade or business if the rules of § 1.863-3(h) were to apply. These rules are intended to ensure that income for which a specific source rule is provided in section 861, 862 or 865 does not produce effectively connected income unless it was earned through functions performed by a U.S. QBU of the taxpayer.

With respect to notional principal contract income and foreign exchange gain or loss, proposed §§ 1.863-3(h) and 1.988-4(h) also provide that such income, gain or loss is effectively connected with the conduct of a U.S. trade or business to the extent that it is sourced to the United States under § 1.863-3(h).

In certain circumstances, the global dealing activities of an entity acting as the agent of a foreign taxpayer in the United States may cause the foreign taxpayer to be engaged in a U.S. trade or business. Any income effectively connected with the U.S. trade or business must be reported by the foreign corporation on a timely filed U.S. tax return in order for the foreign corporation to be eligible for deductions and credits attributable to such income. See § 1.882-4. In addition, the agent must also report any income earned in its capacity as agent on its own tax return. The provisions governing the time and manner for foreign corporations to make elections under §§ 1.882-5 and 1.884-1 remain in force as promulgated. Under current rules, these formalities must be observed even if all of the global dealing income would be allocated between a U.S. corporation and a foreign corporation's U.S. trade or business. The IRS believes that these requirements are justified because of potential differences that might occur with respect to the realization of losses and between actual dividend remittances of a U.S. corporation and deemed dividend remittances under the branch profits tax. The IRS, however, solicits comments regarding whether these filing requirements can be simplified, taking into consideration the policies underlying the filing requirements of § 1.882-4.

The Business Profits article contained in U.S. income tax treaties requires the United States to attribute to a permanent establishment that portion of the income earned by the entity from transactions with third parties that the permanent establishment might be expected to earn if it were an independent enterprise. Because the proposed regulations contained in this document allocate global trading income among permanent establishments under the arm's length principle of the Associated Enterprises article of U.S. income tax treaties, such rules are consistent with our obligations under the Business Profits article. Accordingly, a proposed rule under section 894 provides that, if a taxpayer is engaged in a global dealing operation through a U.S. permanent establishment, the proposed regulations will apply to determine the income attributable to that U.S. permanent establishment under the applicable U.S. income tax treaty.

M. Relationship to Other Regulations

The allocation rules contained herein do not apply to the allocation of interest expense. As discussed in the preamble to § 1.882-5 (TD 8658, 1996-1 CB 161, 162, 61 FR 9326, March 5, 1996), the rules contained in § 1.882-5 are the exclusive rules for allocating interest expense, including under U.S. income tax treaties.

Proposed regulations have been issued under sections 882 and 884 (INTL-0054-95, 1996-1 CB 844, 61 FR 9377, March 5, 1996) for purposes of allocating interest expense and determining the U.S. assets and/or liabilities reflected on the books of a foreign corporation's U.S. trade or business that are attributable to its activities as a dealer under section 475. The proposed regulations (and similar final regulations) under section 884 address the treatment of assets which give rise to both effectively connected and non-effectively connected income. Those rules thus address a situation analogous to the split-sourcing situation addressed in these proposed regulations. The IRS anticipates issuing proposed regulations under section 861 that provide a similar rule for purposes of allocating interest expense of a U.S. corporation that has assets that give rise to split-sourced income. Comments are solicited on the compatibility of the proposed regulations contained in this document with the principles of the proposed regulations that address a foreign corporation's allocation of interest expense, including its computation of U.S. assets included in step 1 of the § 1.882-5 formula and

component liabilities included in steps 2 and 3 of the § 1.882-5 formula.

The IRS believes that the transfer pricing compliance issues associated with a global dealing operation are substantially similar to those raised by related party transactions generally. The IRS also believes that the existing regulations under section 6662 adequately address these issues. Accordingly, amendments have not been proposed to the regulations under section 6662. Section 6662 may not in certain circumstances, however, apply to the computation of effectively connected income in accordance with proposed regulations under section 475, 863, 864 or 988 contained in this document. The IRS will propose regulations under section 6038C regarding the information reporting and recordkeeping requirements applicable to foreign corporations engaged in a global dealing operation. It is anticipated that these regulations will coordinate the application of sections 6662 and 6038C where necessary.

No inference should be drawn from the examples in these proposed regulations concerning the treatment or significance of liquidity and creditworthiness or the effect of such items on the valuation of a security. The purpose of the proposed regulations under section 482 is not to provide guidance on the valuation of a security, but rather to determine whether the prices of controlled transactions satisfy the arm's length standard. Section 475 and the regulations thereunder continue to govern exclusively the valuation of securities.

N. Section 475

A dealer in securities as defined in section 475 is generally required to mark its securities to market. Securities are exempt from mark-to-market accounting if the securities are held for investment or not held for sale to customers and are properly identified on the taxpayer's books and records. Additionally, securities that hedge positions that are not subject to mark-to-market accounting are exempt from mark-to-market accounting if they are properly identified.

Under the current regulations, a taxpayer may not take into account an agreement between separate business units within the same entity that transfers risk management responsibility from a non-dealing business unit to a dealing business unit. Moreover, such an agreement may not be used to allocate income, expense, gain or loss between activities that are accounted for on a mark-to-market basis and activities that are accounted for on a non-mark-to-

market basis. In contrast, the regulations proposed in this document under sections 482, 863, 864, 894, and 988 allow a taxpayer to take into account records of internal transfers when allocating global dealing income earned from third parties for purposes of determining source and effectively connected income. This may cause a mismatch in the timing of income, expense, gain, or loss.

For example, if a taxpayer's lending desk enters into a third-party transaction that exposes the lending desk to currency or interest rate risk, the lending desk may transfer responsibility for managing the risk for that particular transaction to another business activity that can manage the risk more efficiently (e.g., the desk that deals in currency or interest rate derivatives). The dealing desk then, in the ordinary course of its business, may enter into a transaction such as a swap with a third party to hedge the aggregate risk of the dealing desk and, indirectly, the risk incurred by the lending desk with respect to the original transaction. Where, as is generally the case, the dealing desk has a large volume of transactions, it is not possible as a practical matter to associate the aggregate hedge with the risk of the lending desk. Since the transactions entered into by the dealing desk must generally be marked to market, the third-party transaction that hedges the aggregate risk of the dealing desk (which includes the risk transferred from the lending desk) must generally also be marked. To the extent that a portion of the income, expense, gain, or loss from the aggregate hedging transaction is allocated to the lending desk under the proposed global dealing regulations, the potential timing mismatch described above will occur if the lending desk accounts for its positions on a non-mark-to-market basis. This mismatch could occur because the portion of the income, expense, gain, or loss from the hedging transaction, although allocated to the lending desk for sourcing and effectively connected income purposes, will be accounted for on a mark-to-market basis under the dealing desk's method of accounting. Entirely exempting the aggregate hedging transaction from mark-to-market accounting does not adequately solve this problem, because it results in the portion of the income, expense, gain or loss from the aggregate hedging transaction that is allocated to the dealing desk being accounted for on other than a mark-to-market method.

As the example shows, respecting records of internal transfers for purposes of sourcing without respecting these

same records for purposes of timing could produce unpredictable and arbitrary results. Accordingly, the proposed regulations permit participants in a global dealing operation to respect records of internal transfers in applying the timing rules of section 475. Because the need to reconcile sourcing and timing exists only in the context of a cross-border operation, the proposed regulations have a limited scope. In particular, for the proposed regulations to apply, income of the global dealing desk must be subject to allocation among two or more jurisdictions or be sourced to two or more jurisdictions.

The purpose of the proposed regulations under section 475 is to coordinate section 475 with the proposed global dealing regulations and to facilitate identification of the amount of income, expense, gain or loss from third party transactions that is subject to mark-to-market accounting. This rule is not intended to allow a shifting of income inconsistent with the arm's length standard.

Under the proposed section 475 regulations, an interdesk agreement or "risk transfer agreement" (RTA) includes a transfer of responsibility for risk management between a business unit that is hedging some of its risk (the hedging QBU) and another business unit of the same taxpayer that uses mark-to-market accounting (the marking QBU). If the marking QBU, the hedging QBU, and the RTA satisfy certain requirements, the RTA is taken into account for purposes of determining the timing of income allocated by the proposed global dealing regulations to the separate business units of a taxpayer.

The proposed amendments to the section 475 regulations require that the marking QBU must be a dealer within the meaning of proposed § 1.482-8(a)(2)(iii) and that its income must be allocated to at least two jurisdictions under proposed § 1.482-8 or sourced to at least two jurisdictions under proposed § 1.863-3(h). Additionally, the RTA qualifies only if the marking QBU would mark its side of the RTA to market under section 475 if the transaction were with an unrelated third party. Thus, if the marking QBU were to identify the RTA as a hedge of a position that is not subject to mark-to-market accounting (such as debt issued by the marking QBU), the RTA would not qualify. The IRS requests comments on whether the marking QBU should ever be able to exempt its position in the RTA from mark-to-market treatment and account for its position in the RTA.

The proposed amendments to the section 475 regulations are intended to address situations where the hedging QBU transfers responsibility for the management of risk arising from a transaction with a third party. Accordingly, the proposed regulations require that the hedging QBU's position in the RTA would be a hedge within the meaning of § 1.1221-2(b) if the transaction were entered into with an unrelated entity. The IRS solicits comments on whether this requirement is broad enough to address the business needs of entities engaged in global dealing and nondealing activities. Comments suggesting that the requirement should be broadened (e.g., to include risk reduction with respect to capital assets) should address how such a regime could be coordinated with other relevant rules (e.g., the straddle rules). Additionally, if a taxpayer suggests changes to the section 475 rules proposed in this notice, the IRS requests additional comments addressing whether or not corresponding changes should be made to § 1.1221-2(d).

The proposed regulations also require that the RTA be recorded on the books and records of the QBU no later than the time the RTA is effective. RTAs that are not timely recorded do not qualify under the proposed regulations. Additionally, the RTA must be accounted for in a manner that is consistent with the QBU's usual accounting practices.

If all of the requirements of the proposed regulations are satisfied, then for purposes of determining the timing of income, expense, gain, or loss allocated to a QBU under the global dealing regulations, the marking QBU and the hedging QBU account for their respective positions in the RTA as if the position were entered into with an unrelated third party.

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 impact analysis is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that these regulations affect entities who participate in cross-border global dealing of stocks and securities. These regulations affect the source of income and allocation of income, deductions, credits, and allowances among such entities. The primary participants who engage in cross-border global dealing activities are large regulated commercial

banks and brokerage firms, and investment banks. Accordingly, the IRS does not believe that a substantial number of small entities engage in cross-border global dealing activities covered by these regulation. 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 July 9, 1998, at 10 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 June 4, 1998, and submit an outline of the topics to be discussed and the time to be devoted to each topic by June 18, 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 after the date final regulations are published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Ginny Chung of the Office of Associate Chief Counsel (International) and Richard Hoge of the Office of Assistant Chief Counsel (Financial Institutions & 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 is amended by adding entries in numerical order to read as follows:

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

Section 1.475(g)-2 also issued under 26 U.S.C. 475. * * *

Section 1.482-8 also issued under 26 U.S.C. 482. * * *

Section 1.863-3(h) also issued under 26 U.S.C. 863 and 26 U.S.C. 865(j). * * *

Section 1.988-4(h) also issued under 26 U.S.C. 863 and 26 U.S.C. 988. * * *

Par. 2. Section 1.475(g)-2 is added as follows:

§ 1.475(g)-2 Risk transfer agreements in a global dealing operation.

(a) *In general.* This section provides computational rules to coordinate the application of section 475 and § 1.446-4 with rules for allocation and sourcing under the global dealing regulations. If the requirements in paragraph (c) of this section are met, a risk transfer agreement (RTA) (as defined in paragraph (b) of this section) is accounted for under the rules of paragraph (d) of this section.

(b) *Definition of risk transfer agreement.* For purposes of this section, a risk transfer agreement (RTA) is a transfer of risk between two qualified business units (QBUs) (as defined in § 1.989(a)-1(b)) of the same taxpayer such that—

(1) The transfer is consistent with the business practices and risk management policies of each QBU;

(2) The transfer is evidenced in each QBU's books and records;

(3) Each QBU records the RTA on its books and records at a time no later than the time the RTA is effective; and

(4) Except to the extent required by paragraph (b)(3) of this section, the entry in the books and records of each QBU is consistent with that QBU's normal accounting practices.

(c) *Requirements for application of operational rule—*(1) The position in the RTA of one QBU (the hedging QBU) would qualify as a hedging transaction (within the meaning of § 1.1221-2(b)) with respect to that QBU if—

(i) The RTA were a transaction entered into with an unrelated party; and

(ii) For purposes of determining whether the hedging QBU's position satisfies the risk reduction requirement in § 1.1221-2(b), the only risks taken into account are the risks of the hedging QBU (that is, the risks that would be taken into account if the hedging QBU were a separate corporation that had made a separate-entity election under § 1.1221-2(d)(2));

(2) The other QBU (the marking QBU) is a regular dealer in securities (within the meaning of § 1.482-8(a)(2)(iii));

(3) The marking QBU would mark to market its position in the RTA under section 475 if the RTA were a transaction entered into with an unrelated party; and

(4) Income of the marking QBU is subject to allocation under § 1.482-8 to two or more jurisdictions or is sourced under § 1.863-3(h) to two or more jurisdictions.

(d) *Operational rule.* If the requirements in paragraph (c) of this section are met, each QBU that is a party to a RTA (as defined in paragraph (b) of this section) takes its position in the RTA into account as if that QBU had entered into the RTA with an unrelated party. Thus, the marking QBU marks its position to market, and the hedging QBU accounts for its position under § 1.446-4. Because this section only effects coordination with the allocation and sourcing rules, it does not affect factors such as the determination of the amount of interest expense that is incurred by either QBU and that is subject to allocation and apportionment under section 864(e) or 882(c).

Par. 3. Section 1.482-0 is amended as follows:

1. The introductory text is revised.

2. The section heading and entries for § 1.482-8 are redesignated as the section heading and entries for § 1.482-9.

3. A new section heading and entries for § 1.482-8 are added.

The addition and revision read as follows:

§ 1.482-0 Outline of regulations under section 482.

This section contains major captions for §§ 1.482-1 through 1.482-9.

* * * * *

§ 1.482-8 Allocation of income earned in a global dealing operation.

(a) General requirements and definitions.

(1) In general.

(2) Definitions.

(i) Global dealing operation.

(ii) Participant.

(iii) Regular dealer in securities.

(iv) Security.

(3) Factors for determining comparability for a global dealing operation.

(i) Functional analysis.

(ii) Contractual terms.

(iii) Risk.

(iv) Economic conditions.

(4) Arm's length range.

(i) General rule.

(ii) Reliability.

(iii) Authority to make adjustments.

(5) Examples.

(b) Comparable uncontrolled financial transaction method.

(1) General rule.

(2) Comparability and reliability.

(i) In general.

(ii) Adjustments for differences between controlled and uncontrolled transactions.

(iii) Data and assumptions.

(3) Indirect evidence of the price of a comparable uncontrolled financial transaction.

(i) In general.

(ii) Public exchanges or quotation media.

(iii) Limitation on use of public exchanges or quotation media.

(4) Arm's length range.

(5) Examples.

(c) Gross margin method.

(1) General rule.

(2) Determination of an arm's length price.

(i) In general.

(ii) Applicable resale price.

(iii) Appropriate gross profit.

(3) Comparability.

(i) In general.

(ii) Adjustments for differences between controlled and uncontrolled transactions.

(iii) Reliability.

(iv) Data and assumptions.

(A) In general.

(B) Consistency in accounting.

(4) Arm's length range.

(5) Example.

(d) Gross markup method.

(1) General rule.

(2) Determination of an arm's length price.

(i) In general.

(ii) Appropriate gross profit.

(3) Comparability and reliability.

(i) In general.

(ii) Adjustments for differences between controlled and uncontrolled transactions.

(iii) Reliability.

(iv) Data and assumptions.

(A) In general.

(B) Consistency in accounting.

(4) Arm's length range.

(e) Profit split method.

(1) General rule.

(2) Appropriate share of profit and loss.

(i) In general.

(ii) Adjustment of factors to measure contribution clearly.

(3) Definitions.

(4) Application.

(5) Total profit split.

(i) In general.

(ii) Comparability.

(iii) Reliability.

(iv) Data and assumptions.

(A) In general.

(B) Consistency in accounting.

(6) Residual profit split.

(i) In general.

(ii) Allocate income to routine contributions.

(iii) Allocate residual profit.

(iv) Comparability.

(v) Reliability.

(vi) Data and assumptions.

(A) General rule.

(B) Consistency in accounting.

(7) Arm's length range.

(8) Examples.

(f) Unspecified methods.

(g) Source rule for qualified business units.

Par. 4. Section 1.482-1 is amended as follows:

1. In paragraph (a)(1), remove the last sentence and add two new sentences in its place.

2. Revise paragraph (b)(2)(i).

3. In paragraph (c)(1), revise the last sentence.

4. In paragraph (d)(3)(v), revise the last sentence.

5. In paragraph (i), revise the introductory text.

The additions and revisions read as follows:

§ 1.482-1 Allocation of income and deductions among taxpayers.

(a) *In general*—(1) *Purpose and scope.*

* * * Section 1.482-8 elaborates on the rules that apply to controlled entities engaged in a global securities dealing operation. Finally, § 1.482-9 provides examples illustrating the application of the best method rule.

* * * * *

(b) * * *

(2) * * *

(i) *Methods.* Sections 1.482-2 through 1.482-6 and § 1.482-8 provide specific methods to be used to evaluate whether transactions between or among members of the controlled group satisfy the arm's length standard, and if they do not, to determine the arm's length result.

(c) *Best method rule*—(1) *In general.*

* * * See § 1.482-9 for examples of the application of the best method rule.

* * * * *

(d) * * *

(3) * * *

(v) *Property or services.* * * * For guidance concerning the specific comparability considerations applicable to transfers of tangible and intangible property, see §§ 1.482-3 through 1.482-6 and § 1.482-8; see also § 1.482-3(f), dealing with the coordination of the intangible and tangible property rules.

* * * * *

(i) *Definitions.* The definitions set forth in paragraphs (i)(1) through (10) of this section apply to §§ 1.482-1 through 1.482-9.

* * * * *

Par. 5. Section 1.482-2 is amended as follows:

1. In paragraph (a)(3)(iv), revise the first sentence.

2. Revise paragraph (d).

The revisions read as follows:

§ 1.482-2 Determination of taxable income in specific situations.

(a) * * *

(3) * * *

(iv) Fourth, section 482 and paragraphs (b) through (d) of this section and §§ 1.482-3 through 1.482-8, if applicable, may be applied by the district director to make any appropriate allocations, other than an interest rate adjustment, to reflect an arm's length transaction based upon the principal amount of the loan or advance and the interest rate as adjusted under paragraph (a)(3)(i), (ii), or (iii) of this section. * * *

* * * * *

(d) *Transfer of property.* For rules governing allocations under section 482 to reflect an arm's length consideration for controlled transactions involving the transfer of property, see §§ 1.482-3 through 1.482-6 and § 1.482-8.

§ 1.482-8 [Redesignated as § 1.482-9]

Par. 6. Section 1.482-8 is redesignated as § 1.482-9 and a new § 1.482-8 is added to read as follows:

§ 1.482-8 Allocation of income earned in a global securities dealing operation.

(a) *General requirements and definitions—(1) In general.* Where two or more controlled taxpayers are participants in a global dealing operation, the allocation of income, gains, losses, deductions, credits and allowances (referred to herein as income and deductions) from the global dealing operation is determined under this section. The arm's length allocation of income and deductions related to a global dealing operation must be determined under one of the methods listed in paragraphs (b) through (f) of this section. Each of the methods must be applied in accordance with all of the provisions of § 1.482-1, including the best method rule of § 1.482-1(c), the comparability analysis of § 1.482-1(d), and the arm's length range of § 1.482-1(e), as those sections are supplemented or modified in paragraphs (a)(3) and (a)(4) of this section. The available methods are—

(i) The comparable uncontrolled financial transaction method, described in paragraph (b) of this section;

(ii) The gross margin method, described in paragraph (c) of this section;

(iii) The gross markup method, described in paragraph (d) of this section;

(iv) The profit split method, described in paragraph (e) of this section; and

(v) Unspecified methods, described in paragraph (f) of this section.

(2) *Definitions—(i) Global dealing operation.* A global dealing operation consists of the execution of customer transactions, including marketing, sales, pricing and risk management activities, in a particular financial product or line of financial products, in multiple tax jurisdictions and/or through multiple participants, as defined in paragraph (a)(2)(ii) of this section. The taking of proprietary positions is not included within the definition of a global dealing operation unless the proprietary positions are entered into by a regular dealer in securities in its capacity as such a dealer under paragraph (a)(2)(iii) of this section. Lending activities are not included within the definition of a global dealing operation. Therefore, income earned from such lending activities or from securities held for investment is not income from a global dealing operation and is not governed by this section. A global dealing operation may consist of several different business activities engaged in by participants. Whether a separate business activity is a global dealing operation shall be determined with respect to each type of financial product entered on the taxpayer's books and records.

(ii) *Participant—(A)* A participant is a controlled taxpayer, as defined in § 1.482-1(i)(5), that is—

(1) A regular dealer in securities as defined in paragraph (a)(2)(iii) of this section; or

(2) A member of a group of controlled taxpayers which includes a regular dealer in securities, but only if that member conducts one or more activities related to the activities of such dealer.

(B) For purposes of paragraph (a)(2)(ii)(A)(2) of this section, such related activities are marketing, sales, pricing, risk management or brokering activities. Such related activities do not include credit analysis, accounting services, back office services, general supervision and control over the policies of the controlled taxpayer, or the provision of a guarantee of one or more transactions entered into by a regular dealer in securities or other participant.

(iii) *Regular dealer in securities.* For purposes of this section, a regular dealer in securities is a taxpayer that—

(A) Regularly and actively offers to, and in fact does, purchase securities from and sell securities to customers who are not controlled taxpayers in the ordinary course of a trade or business; or

(B) Regularly and actively offers to, and in fact does, enter into, assume, offset, assign or otherwise terminate positions in securities with customers

who are not controlled entities in the ordinary course of a trade or business.

(iv) *Security.* For purposes of this section, a security is a security as defined in section 475(c)(2) or foreign currency.

(3) *Factors for determining comparability for a global dealing operation.* The comparability factors set out in this paragraph (a)(3) must be applied in place of the comparability factors described in § 1.482-1(d)(3) for purposes of evaluating a global dealing operation.

(i) *Functional analysis.* In lieu of the list set forth in § 1.482-1(d)(3)(i)(A) through (H), functions that may need to be accounted for in determining the comparability of two transactions are—

(A) Product research and development;

(B) Marketing;

(C) Pricing;

(D) Brokering; and

(E) Risk management.

(ii) *Contractual terms.* In addition to the terms set forth in § 1.482-1(d)(3)(ii)(A), and subject to § 1.482-1(d)(3)(ii)(B), significant contractual terms for financial products transactions include—

(A) Sales or purchase volume;

(B) Rights to modify or transfer the contract;

(C) Contingencies to which the contract is subject or that are embedded in the contract;

(D) Length of the contract;

(E) Settlement date;

(F) Place of settlement (or delivery);

(G) Notional principal amount;

(H) Specified indices;

(I) The currency or currencies in which the contract is denominated;

(J) Choice of law and jurisdiction governing the contract to the extent chosen by the parties; and

(K) Dispute resolution, including binding arbitration.

(iii) *Risk.* In lieu of the list set forth in § 1.482-1(d)(3), significant risks that could affect the prices or profitability include—

(A) Market risks, including the volatility of the price of the underlying property;

(B) Liquidity risks, including the fact that the property (or the hedges of the property) trades in a thinly traded market;

(C) Hedging risks;

(D) Creditworthiness of the counterparty; and

(E) Country and transfer risk.

(iv) *Economic conditions.* In lieu of the list set forth in § 1.482-1(d)(3)(iv) (A) through (H), significant economic conditions that could affect the prices or profitability include

(A) The similarity of geographic markets;

(B) The relative size and sophistication of the markets;

(C) The alternatives reasonably available to the buyer and seller;

(D) The volatility of the market; and

(E) The time the particular transaction is entered into.

(4) *Arm's length range*—(i) *General rule*. Except as modified in this paragraph (a)(4), § 1.482-1(e) will apply to determine the arm's length range of transactions entered into by a global dealing operation as defined in paragraph (a)(2)(i) of this section. In determining the arm's length range, whether the participant is a buyer or seller is a relevant factor.

(ii) *Reliability*. In determining the reliability of an arm's length range, it is necessary to consider the fact that the market for financial products is highly volatile and participants in a global dealing operation frequently earn only thin profit margins. The reliability of using a statistical range in establishing a comparable price of a financial product in a global dealing operation is based on facts and circumstances. In a global dealing operation, close proximity in time between a controlled transaction and an uncontrolled transaction may be a relevant factor in determining the reliability of the uncontrolled transaction as a measure of the arm's length price. The relevant time period will depend on the price volatility of the particular product.

(iii) *Authority to make adjustments*. The district director may, notwithstanding § 1.482-1(e)(1), adjust a taxpayer's results under a method applied on a transaction by transaction basis if a valid statistical analysis demonstrates that the taxpayer's controlled prices, when analyzed on an aggregate basis, provide results that are not arm's length. See § 1.482-1(f)(2)(iv). This may occur, for example, when there is a pattern of prices in controlled transactions that are higher or lower than the prices of comparable uncontrolled transactions.

(5) *Examples*. The following examples illustrate the principles of this paragraph (a).

Example 1. Identification of participants.

(i) B is a foreign bank that acts as a market maker in foreign currency in country X, the country of which it is a resident. C, a country

Y resident corporation, D, a country Z resident corporation, and USFX, a U.S. resident corporation are all members of a controlled group of taxpayers with B, and each acts as a market maker in foreign currency. In addition to market-making activities conducted in their respective countries, C, D, and USFX each employ marketers and traders, who also perform risk management with respect to their foreign currency operations. In a typical business day, B, C, D, and USFX each enter into several hundred spot and forward contracts to purchase and sell Deutsche marks (DM) with unrelated third parties on the interbank market. In the ordinary course of business, B, C, D, and USFX also enter into contracts to purchase and sell DM with each other.

(ii) Under § 1.482-8(a)(2)(iii), B, C, D, and USFX are each regular dealers in securities because they each regularly and actively offer to, and in fact do, purchase and sell currencies to customers who are not controlled taxpayers, in the ordinary course of their trade or business. Consequently, each controlled taxpayer is also a participant. Together, B, C, D, and USFX conduct a global dealing operation within the meaning of § 1.482-8(a)(2)(i) because they execute customer transactions in multiple tax jurisdictions. Accordingly, the controlled transactions between B, C, D, and USFX are evaluated under the rules of § 1.482-8.

Example 2. Identification of participants.

(i) The facts are the same as in Example 1, except that USFX is the only member of the group of controlled taxpayers that buys from and sells foreign currency to customers. C performs marketing and pricing activities with respect to the controlled group's foreign currency operation. D performs accounting and back office services for B, C, and USFX, but does not perform any marketing, sales, pricing, risk management or brokering activities with respect to the controlled group's foreign currency operation. B provides guarantees for all transactions entered into by USFX.

(ii) Under § 1.482-8(a)(2)(iii), USFX is a regular dealer in securities and therefore is a participant. C also is a participant because it performs activities related to USFX's foreign currency dealing activities. USFX's and C's controlled transactions relating to their DM activities are evaluated under § 1.482-8. D is not a participant in a global dealing operation because its accounting and back office services are not related activities within the meaning of § 1.482-8(a)(2)(ii)(B). B also is not a participant in a global dealing operation because its guarantee function is not a related activity within the meaning of § 1.482-8(a)(2)(ii)(B). Accordingly, the determination of whether transactions between B and D and other members of the controlled group are at arm's length is not determined under § 1.482-8.

Example 3. Scope of a global dealing operation. (i) C, a U.S. resident commercial

bank, conducts a banking business in the United States and in countries X and Y through foreign branches. C regularly and actively offers to, and in fact does, purchase from and sell foreign currency to customers who are not controlled taxpayers in the ordinary course of its trade or business in the United States and countries X and Y. In all the same jurisdictions, C also regularly and actively offers to, and in fact does, enter into, assume, offset, assign, or otherwise terminate positions in interest rate and cross-currency swaps with customers who are not controlled taxpayers. In addition, C regularly makes loans to customers through its U.S. and foreign branches. C regularly sells these loans to a financial institution that repackages the loans into securities.

(ii) C is a regular dealer in securities within the meaning of § 1.482-8(a)(2)(ii) because it purchases and sells foreign currency and enters into interest rate and cross-currency swaps with customers. Because C conducts these activities through U.S. and foreign branches, these activities constitute a global dealing operation within the meaning of § 1.482-8(a)(2)(i). The income, expense, gain or loss from C's global dealing operation is sourced under §§ 1.863-3(h) and 1.988-4(h). Under § 1.482-8(a)(2)(i), C's lending activities are not, however, part of a global dealing operation.

Example 4. Dissimilar products. The facts are the same as in Example 1, but B, C, D, and USFX also act as a market maker in Malaysian ringgit-U.S. dollar cross-currency options in the United States and countries X, Y, and Z. The ringgit is not widely traded throughout the world and is considered a thinly traded currency. The functional analysis required by § 1.482-8(a)(3)(i) shows that the development, marketing, pricing, and risk management of ringgit-U.S. dollar cross-currency option contracts are different than that of other foreign currency contracts, including option contracts. Moreover, the contractual terms, risks, and economic conditions of ringgit-U.S. dollar cross-currency option contracts differ considerably from that of other foreign currency contracts, including option contracts. See § 1.482-8(a)(3)(ii) through (iv). Accordingly, the ringgit-U.S. dollar cross-currency option contracts are not comparable to contracts in other foreign currencies.

Example 5. Relevant time period. (i) USFX is a U.S. resident corporation that is a regular dealer in securities acting as a market maker in foreign currency by buying from and selling currencies to customers. C performs marketing and pricing activities with respect to USFX's foreign currency operation. Trading in Deutsche marks (DM) is conducted between 10:00 a.m. and 10:30 a.m. and between 10:45 a.m. and 11:00 a.m. under the following circumstances.

10:00 a.m.	1.827DM: \$1	Uncontrolled Transaction.
10:04 a.m.	1.827DM: \$1	Controlled Transaction.
10:06 a.m.	1.826DM: \$1	Uncontrolled Transaction.
10:08 a.m.	1.825DM: \$1	Uncontrolled Transaction.
10:10 a.m.	1.827DM: \$1	Controlled Transaction.
10:12 a.m.	1.824DM: \$1	Uncontrolled Transaction.
10:15 a.m.	1.825DM: \$1	Uncontrolled Transaction.

10:18 a.m.	1.826DM: \$1	Controlled Transaction.
10:20 a.m.	1.824DM: \$1	Uncontrolled Transaction.
10:23 a.m.	1.825DM: \$1	Uncontrolled Transaction.
10:25 a.m.	1.825DM: \$1	Uncontrolled Transaction.
10:27 a.m.	1.827DM: \$1	Controlled Transaction.
10:30 a.m.	1.824DM: \$1	Uncontrolled Transaction.
10:45 a.m.	1.822DM: \$1	Uncontrolled Transaction.
10:50 a.m.	1.821DM: \$1	Uncontrolled Transaction.
10:55 a.m.	1.822DM: \$1	Uncontrolled Transaction.
11:00 a.m.	1.819DM: \$1	Uncontrolled Transaction.

(ii) USFX and C are participants in a global dealing operation under § 1.482–8(a)(2)(i). Therefore, USFX determines its arm's length price for its controlled DM contracts under § 1.482–8(a)(4). Under § 1.482–8(a)(4), the relevant arm's length range for setting the prices of USFX's controlled DM transactions occurs between 10:00 a.m. and 10:30 a.m. Because USFX has no controlled transactions between 10:45 a.m. and 11:00 a.m., and the price movement during this later time period continued to decrease, the 10:45 a.m. to 11:00 a.m. time period is not part of the relevant arm's length range for pricing USFX's controlled transactions.

(b) Comparable uncontrolled financial transaction method—

(1) *General rule.* The comparable uncontrolled financial transaction (CUFT) method evaluates whether the amount charged in a controlled financial transaction is arm's length by reference to the amount charged in a comparable uncontrolled financial transaction.

(2) *Comparability and reliability—(i) In general.* The provisions of § 1.482–1(d), as modified by paragraph (a)(3) of this section, apply in determining whether a controlled financial transaction is comparable to a particular uncontrolled financial transaction. All of the relevant factors in paragraph (a)(3) of this section must be considered in determining the comparability of the two financial transactions.

Comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences. Accordingly, unless the controlled taxpayer can demonstrate that the relevant aspects of the controlled and uncontrolled financial transactions are comparable, the reliability of the results as a measure of an arm's length price is substantially reduced.

(ii) *Adjustments for differences between controlled and uncontrolled transactions.* If there are differences between controlled and uncontrolled transactions that would affect price, adjustments should be made to the price of the uncontrolled transaction according to the comparability provisions of § 1.482–1(d)(2) and paragraph (a)(3) of this section.

(iii) *Data and assumptions.* The reliability of the results derived from the

CUFT method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply the method. See § 1.482–1(c)(2)(ii). In the case of a global dealing operation in which the CUFT is set through the use of indirect evidence, participants generally must establish data from a public exchange or quotation media contemporaneously to the time of the transaction, retain records of such data, and upon request furnish to the district director any pricing model used to establish indirect evidence of a CUFT, in order for this method to be a reliable means of evaluating the arm's length nature of the controlled transactions.

(3) *Indirect evidence of the price of a comparable uncontrolled financial transaction—(i) In general.* The price of a CUFT may be derived from data from public exchanges or quotation media if the following requirements are met—

(A) The data is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled sales;

(B) The data derived from public exchanges or quotation media is used to set prices in the controlled transaction in the same way it is used for uncontrolled transactions of the taxpayer, or the same way it is used by uncontrolled taxpayers; and

(C) The amount charged in the controlled transaction is adjusted to reflect differences in quantity, contractual terms, counterparties, and other factors that affect the price to which uncontrolled taxpayers would agree.

(ii) *Public exchanges or quotation media.* For purposes of paragraph (b)(3)(i) of this section, an established financial market, as defined in § 1.1092(d)–1(b), qualifies as a public exchange or a quotation media.

(iii) *Limitation on use of data from public exchanges or quotation media.* Use of data from public exchanges or quotation media is not appropriate under extraordinary market conditions. For example, under circumstances where the trading or transfer of a particular country's currency has been suspended or blocked by another country, causing significant instability

in the prices of foreign currency contracts in the suspended or blocked currency, the prices listed on a quotation medium may not reflect a reliable measure of an arm's length result.

(4) *Arm's length range.* See § 1.482–1(e)(2) and paragraph (a)(4) of this section for the determination of an arm's length range.

(5) *Examples.* The following examples illustrate the principles of this paragraph (b).

Example 1. Comparable uncontrolled financial transactions. (i) B is a foreign bank resident in country X that acts as a market maker in foreign currency in country X. C, a country Y resident corporation, D, a country Z resident corporation, and USFX, a U.S. resident corporation are all members of a controlled group of taxpayers with B, and each acts as a market maker in foreign currency. In addition to market making activities conducted in their respective countries, C, D, and USFX each employ marketers and traders, who also perform risk management with respect to their foreign currency operations. In a typical business day, B, C, D, and USFX each enter into several hundred spot and forward contracts to purchase and sell Deutsche marks (DM) with unrelated third parties on the interbank market. In the ordinary course of business, B, C, D, and USFX also each enter into contracts to purchase and sell DM with each other. On a typical day, no more than 10% of USFX's DM trades are with controlled taxpayers. USFX's DM-denominated spot and forward contracts do not vary in their terms, except as to the volume of DM purchased or sold. The differences in volume of DM purchased and sold by USFX do not affect the pricing of the DM. USFX maintains contemporaneous records of its trades, accounted for by type of trade and counterparty. The daily volume of USFX's DM-denominated spot and forward contracts consistently provides USFX with third party transactions that are contemporaneous with the transactions between controlled taxpayers.

(ii) Under § 1.482–8(a)(2)(iii), B, C, D, and USFX each are regular dealers in securities because they each regularly and actively offer to, and in fact do, purchase and sell currencies to customers who are not controlled taxpayers, in the ordinary course of their trade or business. Consequently, each controlled taxpayer is also a participant. Together, B, C, D, and USFX conduct a global dealing operation within the meaning of § 1.482–8(a)(2)(i) because they execute

customer transactions in multiple tax jurisdictions. To determine the comparability of USFX's controlled and uncontrolled DM-denominated spot and forward transactions, the factors in § 1.482-8(a)(3) must be considered. USFX performs the same functions with respect to controlled and uncontrolled DM-denominated spot and forward transactions. See § 1.482-8(a)(3)(i). In evaluating the contractual terms under § 1.482-8(a)(3)(ii), it is determined that the volume of DM transactions varies, but these variances do not affect the pricing of USFX's uncontrolled DM transactions. Taking into account the risk factors of § 1.482-8(a)(3)(iii), USFX's risk associated with both the controlled and uncontrolled DM transactions does not vary in any material respect. In applying the significant factors for evaluating the economic conditions under § 1.482-8(a)(3)(iv), USFX has sufficient third party DM transactions to establish comparable economic conditions for evaluating an arm's length price. Accordingly, USFX's uncontrolled transactions are comparable to its controlled transactions in DM spot and forward contracts.

Example 2. Lack of comparable uncontrolled financial transactions. The facts are the same as in Example 1, except that USFX trades Italian lira (lira) instead of DM. USFX enters into few uncontrolled and controlled lira-denominated forward contracts each day. The daily volume of USFX's lira forward purchases and sales does not provide USFX with sufficient third party transactions to establish that uncontrolled transactions are sufficiently contemporaneous with controlled transactions to be comparable within the meaning of § 1.482-8(a)(3). In applying the comparability factors of § 1.482-8(a)(3), and of paragraph (a)(3)(iv) of this section in particular, USFX's controlled and uncontrolled lira forward purchases and sales are not entered into under comparable economic conditions. Accordingly, USFX's uncontrolled transactions in lira forward contracts are not comparable to its controlled lira forward transactions.

Example 3. Indirect evidence of the price of a comparable uncontrolled financial transaction. (i) The facts are the same as in Example 2, except that USFX uses a computer quotation system (CQS) that is an interdealer market, as described in § 1.1092(d)-1(b)(2), to set its price on lira forward contracts with controlled and uncontrolled taxpayers. Other financial institutions also use CQS to set their prices on lira forward contracts. CQS is an established financial market within the meaning of § 1.1092(d)-1(b).

(ii) Because CQS is an established financial market, it is a public exchange or quotation media within the meaning of § 1.482-8(b)(3)(i). Because other financial institutions use prices from CQS in the same manner as USFX, prices derived from CQS are deemed to be widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled sales. See § 1.482-8(b)(3)(i)(A) and (B). If USFX adjusts the price quoted by CQS under the criteria specified in § 1.482-8(b)(2)(ii)(A)(3), the controlled price derived by USFX from CQS

qualifies as indirect evidence of the price of a comparable uncontrolled financial transaction.

Example 4. Indirect evidence of the price of a comparable uncontrolled financial transaction—internal pricing models. (i) T is a U.S. resident corporation that acts as a market maker in U.S. dollar-denominated notional principal contracts. T's marketers and traders work together to sell notional principal contracts (NPCs), primarily to T's North and South American customers. T typically earns 4 basis points at the inception of each standard 3 year U.S. dollar-denominated interest rate swap that is entered into with an unrelated, financially sophisticated, creditworthy counterparty. TS, T's wholly owned U.K. subsidiary, also acts as a market maker in U.S. dollar-denominated NPCs, employing several traders and marketers who initiate contracts primarily with European customers. On occasion, for various business reasons, TS enters into a U.S. dollar-denominated NPC with T. The U.S. dollar-denominated NPCs that T enters into with unrelated parties are comparable in all material respects to the transactions that T enters into with TS. TS prices all transactions with T using the same pricing models that TS uses to price transactions with third parties. The pricing models analyze relevant data, such as interest rates and volatilities, derived from public exchanges. TS records the data that were used to determine the price of each transaction at the time the transaction was entered into. Because the price produced by the pricing models is a mid-market price, TS adjusts the price so that it receives the same 4 basis point spread on its transaction with T that it would earn on comparable transactions with comparable counterparties during the same relevant time period.

(ii) Under § 1.482-8(a)(2), T and TS are participants in a global dealing operation that deals in U.S. dollar-denominated NPCs. Because the prices produced by TS's pricing model are derived from information on public exchanges and TS uses the same pricing model to set prices for controlled and uncontrolled transactions, the requirements of § 1.482-8(b)(3)(i)(A) and (B) are met. Because the U.S. dollar-denominated NPCs that T enters into with customers (uncontrolled transactions) are comparable to the transactions between T and TS within the meaning of § 1.482-8(a)(3) and TS earns 4 basis points at inception of its uncontrolled transactions that are comparable to its controlled transactions, TS has also satisfied the requirements of § 1.482-8(b)(3)(i)(C). Accordingly, the price produced by TS's pricing model constitutes indirect evidence of the price of a comparable uncontrolled financial transaction.

(c) Gross margin method—(1) General rule. The gross margin method evaluates whether the amount allocated to a participant in a global dealing operation is arm's length by reference to the gross profit margin realized on the sale of financial products in comparable uncontrolled transactions. The gross margin method may be used to establish an arm's length price for a transaction

where a participant resells a financial product to an unrelated party that the participant purchased from a related party. The gross margin method may apply to transactions involving the purchase and resale of debt and equity instruments. The method may also be used to evaluate whether a participant has received an arm's length commission for its activities in a global dealing operation when the participant has not taken title to a security or has not become a party to a derivative financial product. To meet the arm's length standard, the gross profit margin on controlled transactions should be similar to that of comparable uncontrolled transactions.

(2) Determination of an arm's length price—(i) In general. The gross margin method measures an arm's length price by subtracting the appropriate gross profit from the applicable resale price for the financial product involved in the controlled transaction under review.

(ii) Applicable resale price. The applicable resale price is equal to either the price at which the financial product involved is sold in an uncontrolled sale or the price at which contemporaneous resales of the same product are made. If the product purchased in the controlled sale is resold to one or more related parties in a series of controlled sales before being resold in an uncontrolled sale, the applicable resale price is the price at which the product is resold to an uncontrolled party, or the price at which contemporaneous resales of the same product are made. In such case, the determination of the appropriate gross profit will take into account the functions of all members of the controlled group participating in the series of controlled sales and final uncontrolled resales, as well as any other relevant factors described in paragraph (a)(3) of this section.

(iii) Appropriate gross profit. The appropriate gross profit is computed by multiplying the applicable resale price by the gross profit margin, expressed as a percentage of total revenue derived from sales, earned in comparable uncontrolled transactions.

(3) Comparability and reliability—(i) In general. The provisions of § 1.482-1(d), as modified by paragraph (a)(3) of this section, apply in determining whether a controlled transaction is comparable to a particular uncontrolled transaction. All of the factors described in paragraph (a)(3) of this section must be considered in determining the comparability of two financial products transactions, including the functions performed. The gross margin method considers whether a participant has earned a sufficient gross profit margin

on the resale of a financial product (or line of products) given the functions performed by the participant. A reseller's gross profit margin provides compensation for performing resale functions related to the product or products under review, including an operating profit in return for the reseller's investment of capital and the assumption of risks. Accordingly, where a participant does not take title, or does not become a party to a financial product, the reseller's return to capital and assumption of risk are additional factors that must be considered in determining an appropriate gross profit margin. An appropriate gross profit margin primarily should be derived from comparable uncontrolled purchases and resales of the reseller involved in the controlled sale. This is because similar characteristics are more likely to be found among different resales of a financial product or products made by the same reseller than among sales made by other resellers. In the absence of comparable uncontrolled transactions involving the same reseller, an appropriate gross profit margin may be derived from comparable uncontrolled transactions of other resellers.

(ii) *Adjustments for differences between controlled and uncontrolled transactions.* If there are material differences between controlled and uncontrolled transactions that would affect the gross profit margin, adjustments should be made to the gross profit margin earned in the uncontrolled transaction according to the comparability provisions of § 1.482-1(d)(2) and paragraph (a)(3) of this section. For this purpose, consideration of operating expenses associated with functions performed and risks assumed may be necessary because differences in functions performed are often reflected in operating expenses. The effect of a difference in functions performed on gross profit, however, is not necessarily equal to the difference in the amount of related operating expenses.

(iii) *Reliability.* In order for the gross margin method to be considered a reliable measure of an arm's length price, the gross profit should ordinarily represent an amount that would allow the participant who resells the product to recover its expenses (whether directly related to selling the product or more generally related to maintaining its operations) and to earn a profit commensurate with the functions it performed. The gross margin method may be a reliable means of establishing an arm's length price where there is a purchase and resale of a financial product and the participant who resells

the property does not substantially participate in developing a product or in tailoring the product to the unique requirements of a customer prior to the resale.

(iv) *Data and assumptions—(A) In general.* The reliability of the results derived from the gross margin method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply the method. See § 1.482-1(c)(2)(ii). A participant may establish the gross margin by comparing the bid and offer prices on a public exchange or quotation media. In such case, the prices must be contemporaneous to the controlled transaction, and the participant must retain records of such data.

(B) *Consistency in accounting.* The degree of consistency in accounting practices between the controlled transaction and the uncontrolled transactions may affect the reliability of the gross margin method. For example, differences as between controlled and uncontrolled transactions in the method used to value similar financial products (including methods of accounting, methods of estimation, and the timing for changes of such methods) could affect the gross profit. The ability to make reliable adjustments for such differences could affect the reliability of the results.

(4) *Arm's length range.* See § 1.482-1(e)(2) and paragraph (a)(4) of this section for the determination of an arm's length range.

(5) *Example.* The following example illustrates the principles of this paragraph (c).

Example 1. Gross margin method. (i) T is a U.S. resident financial institution that acts as a market maker in debt and equity instruments issued by U.S. corporations. Most of T's sales are to U.S.-based customers. TS, T's U.K. subsidiary, acts as a market maker in debt and equity instruments issued by European corporations and conducts most of its business with European-based customers. On occasion, however, a customer of TS wishes to purchase a security that is either held by or more readily accessible to T. To facilitate this transaction, T sells the security it owns or acquires to TS, who then promptly sells it to the customer. T and TS generally derive the majority of their profit on the difference between the price at which they purchase and the price at which they sell securities (the bid/offer spread). On average, TS's gross profit margin on its purchases and sales of securities from unrelated persons is 2%. Applying the comparability factors specified in § 1.482-8(a)(3), T's purchases and sales with unrelated persons are comparable to the purchases and sales between T and TS.

(ii) Under § 1.482-8(a)(2), T and TS are participants in a global dealing operation that

deals in debt and equity securities. Since T's related purchases and sales are comparable to its unrelated purchases and sales, if TS's gross profit margin on purchases and sales of comparable securities from unrelated persons is 2%, TS should also typically earn a 2% gross profit on the securities it purchases from T. Thus, when TS resells for \$100 a security that it purchased from T, the arm's length price at which TS would have purchased the security from T would normally be \$98 (\$100 sales price minus (2% gross profit margin \times \$100)).

(d) *Gross markup method—(1) General rule.* The gross markup method evaluates whether the amount allocated to a participant in a global dealing operation is arm's length by reference to the gross profit markup realized in comparable uncontrolled transactions. The gross markup method may be used to establish an arm's length price for a transaction where a participant purchases a financial product from an unrelated party that the participant sells to a related party. This method may apply to transactions involving the purchase and resale of debt and equity instruments. The method may also be used to evaluate whether a participant has received an arm's length commission for its role in a global dealing operation when the participant has not taken title to a security or has not become a party to a derivative financial product. To meet the arm's length standard, the gross profit markup on controlled transactions should be similar to that of comparable uncontrolled transactions.

(2) *Determination of an arm's length price—(i) In general.* The gross markup method measures an arm's length price by adding the appropriate gross profit to the participant's cost or anticipated cost, of purchasing, holding, or structuring the financial product involved in the controlled transaction under review (or in the case of a derivative financial product, the initial net present value, measured by the anticipated cost of purchasing, holding, or structuring the product).

(ii) *Appropriate gross profit.* The appropriate gross profit is computed by multiplying the participant's cost or anticipated cost of purchasing, holding, or structuring a transaction by the gross profit markup, expressed as a percentage of cost, earned in comparable uncontrolled transactions.

(3) *Comparability and reliability—(i) In general.* The provisions of § 1.482-1(d), as modified by paragraph (a)(3) of this section, apply in determining whether a controlled transaction is comparable to a particular uncontrolled transaction. All of the factors described in paragraph (a)(3) of this section must be considered in determining the

comparability of two financial products transactions, including the functions performed. The gross markup method considers whether a participant has earned a sufficient gross markup on the sale of a financial product, or line of products, given the functions it has performed. A participant's gross profit markup provides compensation for purchasing, hedging, and transactional structuring functions related to the transaction under review, including an operating profit in return for the investment of capital and the assumption of risks. Accordingly, where a participant does not take title, or does not become a party to a financial product, the reseller's return to capital and assumption of risk are additional factors that must be considered in determining the gross profit markup. An appropriate gross profit markup primarily should be derived from comparable uncontrolled purchases and sales of the participant involved in the controlled sale. This is because similar characteristics are more likely to be found among different sales of property made by the same participant than among sales made by other resellers. In the absence of comparable uncontrolled transactions involving the same participant, an appropriate gross profit markup may be derived from comparable uncontrolled transactions of other parties whether or not such parties are members of the same controlled group.

(ii) *Adjustments for differences between controlled and uncontrolled transactions.* If there are material differences between controlled and uncontrolled transactions that would affect the gross profit markup, adjustments should be made to the gross profit markup earned in the uncontrolled transaction according to the comparability provisions of § 1.482-1(d)(2) and paragraph (a)(3) of this section. For this purpose, consideration of operating expenses associated with the functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses. The effect of a difference in functions on gross profit, however, is not necessarily equal to the difference in the amount of related operating expenses.

(iii) *Reliability.* In order for the gross markup method to be considered a reliable measure of an arm's length price, the gross profit should ordinarily represent an amount that would allow the participant who purchases the product to recover its expenses (whether directly related to selling the product or more generally related to maintaining its operations) and to earn a profit

commensurate with the functions it performed. As with the gross margin method, the gross markup method may be a reliable means of establishing an arm's length price where there is a purchase and resale of a financial product and the participant who resells the property does not substantially participate in developing a product or in tailoring the product to the unique requirements of a customer prior to the resale.

(iv) *Data and assumptions—(A) In general.* The reliability of the results derived from the gross markup method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply the method. See § 1.482-1(c)(2)(ii). A participant may establish the gross markup by comparing the bid and offer prices on a public exchange or quotation media. In such case, the prices must be contemporaneous with the controlled transaction, and the participant must retain records of such data.

(B) *Consistency in accounting.* The degree of consistency in accounting practices between the controlled transaction and the uncontrolled transactions may affect the reliability of the gross markup method. For example, differences as between controlled and uncontrolled transactions in the method used to value similar financial products (including methods in accounting, methods of estimation, and the timing for changes of such methods) could affect the gross profit. The ability to make reliable adjustments for such differences could affect the reliability of the results.

(4) *Arm's length range.* See § 1.482-1(e)(2) and paragraph (a)(4) of this section for the determination of an arm's length range.

(e) *Profit split method—(1) General rule.* The profit split method evaluates whether the allocation of the combined operating profit or loss of a global dealing operation to one or more participants is at arm's length by reference to the relative value of each participant's contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most narrowly identifiable business activity of the participants for which data is available that includes the controlled transactions (relevant business activity).

(2) *Appropriate share of profit and loss—(i) In general.* The relative value of each participant's contribution to the global dealing activity must be determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant

in the activity, consistent with the comparability provisions of § 1.482-1(d), as modified by paragraph (a)(3) of this section. Such an allocation is intended to correspond to the division of profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing functions similar to those of the various controlled taxpayers engaged in the relevant business activity. The relative value of the contributions of each participant in the global dealing operation should be measured in a manner that most reliably reflects each contribution made to the global dealing operation and each participant's role in that contribution. In appropriate cases, the participants may find that a multi-factor formula most reliably measures the relative value of the contributions to the profitability of the global dealing operation. The profit allocated to any particular participant using a profit split method is not necessarily limited to the total operating profit from the global dealing operation. For example, in a given year, one participant may earn a profit while another participant incurs a loss, so long as the arrangement is comparable to an arrangement to which two uncontrolled parties would agree. In addition, it may not be assumed that the combined operating profit or loss from the relevant business activity should be shared equally or in any other arbitrary proportion. The specific method must be determined under paragraph (e)(4) of this section.

(ii) *Adjustment of factors to measure contribution clearly.* In order to reliably measure the value of a participant's contribution, the factors, for example, those used in a multi-factor formula, must be expressed in units of measure that reliably quantify the relative contribution of the participant. If the data or information is influenced by factors other than the value of the contribution, adjustments must be made for such differences so that the factors used in the formula only measure the relative value of each participant's contribution. For example, if trader compensation is used as a factor to measure the value added by the participant's trading expertise, adjustments must be made for variances in compensation paid to traders due solely to differences in the cost of living.

(3) *Definitions.* The definitions in this paragraph (e)(3) apply for purposes of applying the profit split methods in this paragraph (e).

Gross profit is gross income earned by the global dealing operation.

Operating expenses includes all expenses not included in the computation of gross profit, except for

interest, foreign income taxes as defined in § 1.901-2(a), domestic income taxes, and any expenses not related to the global dealing activity that is evaluated under the profit split method. With respect to interest expense, see section 864(e) and the regulations thereunder and § 1.882-5.

Operating profit or loss is gross profit less operating expenses, and includes all income, expense, gain, loss, credits or allowances attributable to each global dealing activity that is evaluated under the profit split method. It does not include income, expense, gain, loss, credits or allowances from activities that are not evaluated under the profit split method, nor does it include extraordinary gains or losses that do not relate to the continuing global dealing activities of the participant.

(4) *Application.* Profit or loss shall be allocated under the profit split method using either the total profit split, described in paragraph (e)(5) of this section, or the residual profit split, described in paragraph (e)(6) of this section.

(5) *Total profit split*—(i) *In general.* The total profit split derives the percentage of the combined operating profit of the participants in a global dealing operation allocable to a participant in the global dealing operation by evaluating whether uncontrolled taxpayers who perform similar functions, assume similar risks, and employ similar resources would allocate their combined operating profits in the same manner.

(ii) *Comparability.* The total profit split evaluates the manner by which comparable uncontrolled taxpayers divide the combined operating profit of a particular global dealing activity. The degree of comparability between the controlled and uncontrolled taxpayers is determined by applying the comparability standards of § 1.482-1(d), as modified by paragraph (a)(3) of this section. In particular, the functional analysis required by § 1.482-1(d)(3)(i) and paragraph (a)(3)(i) of this section is essential to determine whether two situations are comparable. Nevertheless, in certain cases, no comparable ventures between uncontrolled taxpayers may exist. In this situation, it is necessary to analyze the remaining factors set forth in paragraph (a)(3) of this section that could affect the division of operating profits between parties. If there are differences between the controlled and uncontrolled taxpayers that would materially affect the division of operating profit, adjustments must be made according to the provisions of § 1.482-1(d)(2) and paragraph (a)(3) of this section.

(iii) *Reliability.* As indicated in § 1.482-1(c)(2)(i), as the degree of comparability between the controlled and uncontrolled transactions increases, the reliability of a total profit split also increases. In a global dealing operation, however, the absence of external market benchmarks (for example, joint ventures between uncontrolled taxpayers) on which to base the allocation of operating profits does not preclude use of this method if the allocation of the operating profit takes into account the relative contribution of each participant. The reliability of this method is increased to the extent that the allocation has economic significance for purposes other than tax (for example, satisfying regulatory standards and reporting, or determining bonuses paid to management or traders). The reliability of the analysis under this method may also be enhanced by the fact that all parties to the controlled transaction are evaluated under this method. The reliability of the results, however, of an analysis based on information from all parties to a transaction is affected by the reliability of the data and assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

(iv) *Data and assumptions*—(A) *In general.* The reliability of the results derived from the total profit split method is affected by the quality of the data used and the assumptions used to apply the method. See § 1.482-1(c)(2)(ii). The reliability of the allocation of income, expense, or other attributes between the participants' relevant business activities and the participants' other activities will affect the reliability of the determination of the combined operating profit and its allocation among the participants. If it is not possible to allocate income, expense, or other attributes directly based on factual relationships, a reasonable allocation formula may be used. To the extent direct allocations are not made, the reliability of the results derived from application of this method is reduced relative to the results of a method that requires fewer allocations of income, expense, and other attributes. Similarly, the reliability of the results derived from application of this method is affected by the extent to which it is possible to apply the method to the participants' financial data that is related solely to the controlled transactions. For example, if the

relevant business activity is entering into interest rate swaps with both controlled and uncontrolled taxpayers, it may not be possible to apply the method solely to financial data related to the controlled transactions. In such case, the reliability of the results derived from application of this method will be reduced.

(B) *Consistency in accounting.* The degree of consistency between the controlled and uncontrolled taxpayers in accounting practices that materially affect the items that determine the amount and allocation of operating profit affects the reliability of the result. Thus, for example, if differences in financial product valuation or in cost allocation practices would materially affect operating profit, the ability to make reliable adjustments for such differences would affect the reliability of the results.

(6) *Residual profit split*—(i) *In general.* The residual profit split allocates the combined operating profit or loss between participants following the two-step process set forth in paragraphs (e)(6)(ii) and (iii) of this section.

(ii) *Allocate income to routine contributions.* The first step allocates operating income to each participant to provide an arm's length return for its routine contributions to the global dealing operation. Routine contributions are contributions of the same or similar kind as those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns. Routine contributions ordinarily include contributions of tangible property, services, and intangibles that are generally owned or performed by uncontrolled taxpayers engaged in similar activities. For example, transactions processing and credit analysis are typically routine contributions. In addition, a participant that guarantees obligations of or otherwise provides credit support to another controlled taxpayer in a global dealing operation is regarded as making a routine contribution. A functional analysis is required to identify the routine contributions according to the functions performed, risks assumed, and resources employed by each of the participants. Market returns for the routine contributions should be determined by reference to the returns achieved by uncontrolled taxpayers engaged in similar activities, consistent with the methods described in §§ 1.482-2 through 1.482-4 and this § 1.482-8.

(iii) *Allocate residual profit.* The allocation of income to the participant's routine contributions will not reflect

profits attributable to each participant's valuable nonroutine contributions to the global dealing operation. Thus, in cases where valuable nonroutine contributions are present, there normally will be an unallocated residual profit after the allocation of income described in paragraph (e)(6)(ii) of this section. Under this second step, the residual profit generally should be divided among the participants based upon the relative value of each of their nonroutine contributions. Nonroutine contributions are contributions so integral to the global dealing operation that it is impossible to segregate them from the operation and find a separate market return for the contribution. Pricing and risk managing financial products almost invariably involve nonroutine contributions. Similarly, product development and information technology are generally nonroutine contributions. Marketing may be a nonroutine contribution if the marketer substantially participates in developing a product or in tailoring the product to the unique requirements of a customer. The relative value of the nonroutine contributions of each participant in the global dealing operation should be measured in a manner that most reliably reflects each nonroutine contribution made to the global dealing operation and each participant's role in the nonroutine contributions.

(iv) *Comparability*. The first step of the residual profit split relies on external market benchmarks of profitability. Thus, the comparability considerations that are relevant for the first step of the residual profit split are those that are relevant for the methods that are used to determine market returns for routine contributions. In the second step of the residual profit split, however, it may not be possible to rely as heavily on external market benchmarks. Nevertheless, in order to divide the residual profits of a global dealing operation in accordance with each participant's nonroutine contributions, it is necessary to apply the comparability standards of § 1.482-1(d), as modified by paragraph (a)(3) of this section. In particular, the functional analysis required by § 1.482-1(d)(3)(i) and paragraph (a)(3)(i) of this section is essential to determine whether two situations are comparable. Nevertheless, in certain cases, no comparable ventures between uncontrolled taxpayers may exist. In this situation, it is necessary to analyze the remaining factors set forth in paragraph (a)(3) of this section that could affect the division of operating profits between parties. If there are differences between the controlled and

uncontrolled taxpayers that would materially affect the division of operating profit, adjustments must be made according to the provisions of § 1.482-1(d)(2) and paragraph (a)(3) of this section.

(v) *Reliability*. As indicated in § 1.482-1(c)(2)(i), as the degree of comparability between the controlled and uncontrolled transactions increases, the reliability of a residual profit split also increases. In a global dealing operation, however, the absence of external market benchmarks (for example, joint ventures between uncontrolled taxpayers) on which to base the allocation of operating profits does not preclude use of this method if the allocation of the residual profit takes into account the relative contribution of each participant. The reliability of this method is increased to the extent that the allocation has economic significance for purposes other than tax (for example, satisfying regulatory standards and reporting, or determining bonuses paid to management or traders). The reliability of the analysis under this method may also be enhanced by the fact that all parties to the controlled transaction are evaluated under this method. The reliability of the results, however, of an analysis based on information from all parties to a transaction is affected by the reliability of the data and assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

(vi) *Data and assumptions*—(A) *General rule*. The reliability of the results derived from the residual profit split is measured under the standards set forth in paragraph (e)(5)(iv)(A) of this section.

(B) *Consistency in accounting*. The degree of accounting consistency between controlled and uncontrolled taxpayers is measured under the standards set forth in paragraph (e)(5)(iv)(B) of this section.

(7) *Arm's length range*. See § 1.482-1(e)(2) and paragraph (a)(4) of this section for the determination of an arm's length range.

(8) *Examples*. The following examples illustrate the principles of this paragraph (e).

Example 1. Total profit split. (i) P, a U.S. corporation, establishes a separate U.S. subsidiary (USsub) to conduct a global dealing operation in over-the-counter derivatives. USsub in turn establishes subsidiaries incorporated and doing business

in the U.K. (UKsub) and Japan (Jsub). USsub, UKsub, and Jsub each employ marketers and traders who work closely together to design and sell derivative products to meet the particular needs of customers. Each also employs personnel who process and confirm trades, reconcile trade tickets and provide ongoing administrative support (back office services) for the global dealing operation. The global dealing operation maintains a single common book for each type of risk, and the book is maintained where the head trader for that type of risk is located. Thus, notional principal contracts denominated in North and South American currencies are booked in USsub, notional principal contracts denominated in European currencies are booked in UKsub, and notional principal contracts denominated in Japanese yen are booked in Jsub. However, each of the affiliates has authorized a trader located in each of the other affiliates to risk manage its books during periods when the booking location is closed. This grant of authority is necessary because marketers, regardless of their location, are expected to sell all of the group's products, and need to receive pricing information with respect to products during their clients business hours, even if the booking location is closed. Moreover, P is known for making a substantial amount of its profits from trading activities, and frequently does not hedge the positions arising from its customer transactions in an attempt to profit from market changes. As a result, the traders in "off-hours" locations must have a substantial amount of trading authority in order to react to market changes.

(ii) Under § 1.482-8(a)(2), USsub, UKsub and Jsub are participants in a global dealing operation in over-the-counter derivatives. P determines that the total profit split method is the best method to allocate an arm's length amount of income to each participant. P allocates the operating profit from the global dealing operation between USsub, UKsub and Jsub on the basis of the relative compensation paid to marketers and traders in each location. In making the allocation, P adjusts the compensation amounts to account for factors unrelated to job performance, such as the higher cost of living in certain jurisdictions. Because the traders receive significantly greater compensation than marketers in order to account for their greater contribution to the profits of the global dealing operation, P need not make additional adjustments or weight the compensation of the traders more heavily in allocating the operating profit between the affiliates. For rules concerning the source of income allocated to USsub, UKsub and Jsub (and any U.S. trade or business of the participants), see § 1.863-3(h).

Example 2. Total profit split. The facts are the same as in Example 1, except that the labor market in Japan is such that traders paid by Jsub are paid the same as marketers paid by Jsub at the same seniority level, even though the traders contribute substantially more to the profitability of the global dealing operation. As a result, the allocation method used by P is unlikely to compensate the functions provided by each affiliate so as to be a reliable measure of an arm's length result under §§ 1.482-8(e)(2) and 1.482-

1(c)(1), unless P weights the compensation of traders more heavily than the compensation of marketers or develops another method of measuring the contribution of traders to the profitability of the global dealing operation.

Example 3. Total profit split. The facts are the same as in Example 2, except that, in P's annual report to shareholders, P divides its operating profit from customer business into "dealing profit" and "trading profit."

Because both marketers and traders are involved in the dealing function, P divides the "dealing profit" between the affiliates on the basis of the relative compensation of marketers and traders. However, because only the traders contribute to the trading profit, P divides the trading profit between the affiliates on the basis of the relative compensation only of the traders. In making that allocation, P must adjust the compensation of traders in Jsub in order to account for factors not related to job performance.

Example 4. Total profit split. The facts are the same as in Example 1, except that P is required by its regulators to hedge its customer positions as much as possible and therefore does not earn any "trading profit." As a result, the marketing intangibles, such as customer relationships, are relatively more important than the intangibles used by traders. Accordingly, P must weight the compensation of marketers more heavily than the compensation of traders in order to take into account accurately the contribution each function makes to the profitability of the business.

Example 5. Residual profit split. (i) P is a U.S. corporation that engages in a global dealing operation in foreign currency options directly and through controlled taxpayers that are incorporated and operate in the United Kingdom (UKsub) and Japan (Jsub). Each controlled taxpayer is a participant in a global dealing operation. Each participant employs marketers and traders who work closely together to design and sell foreign currency options that meet the particular needs of customers. Each participant also employs salespeople who sell foreign currency options with standardized terms and conditions, as well as other financial products offered by the controlled group. The traders in each location risk manage a common book of transactions during the relevant business hours of each location. P has a AAA credit rating and is the legal counterparty to all third party transactions. The traders in each location have discretion to execute contracts in the name of P. UKsub employs personnel who process and confirm trades, reconcile trade tickets, and provide ongoing administrative support (back office services) for all the participants in the global dealing operation. The global dealing operation has generated \$192 of operating profit for the period.

(ii) After analyzing the foreign currency options business, has determined that the residual profit split method is the best method to allocate the operating profit of the global dealing operation and to determine an arm's length amount of compensation allocable to each participant in the global dealing operation.

(iii) The first step of the residual profit split method (§ 1.482-8(e)(6)(ii)) requires P to

identify the routine contributions performed by each participant. P determines that the functions performed by the salespeople are routine. P determines that the arm's length compensation for salespeople is \$3, \$4, and \$5 in the United States, the United Kingdom, and Japan, respectively. Thus, P allocates \$3, \$4, and \$5 to P, UKsub, and Jsub, respectively.

(iv) Although the back office function would not give rise to participant status, in the context of a residual profit split allocation, the back office function is relevant for purposes of receiving remuneration for routine contributions to a global dealing operation. P determines that an arm's length compensation for the back office is \$20. Since the back office services constitute routine contributions, \$20 of income is allocated to UKsub under step 1 of the residual profit split method. In addition, P determines that the comparable arm's length compensation for the risk to which P is subject as counterparty is \$40. Accordingly, \$40 is allocated to P as compensation for acting as counterparty to the transactions entered into in P's name by Jsub and UKsub.

(v) The second step of the residual profit split method (§ 1.482-8(e)(6)(iii)) requires that the residual profit be allocated to participants according to the relative value of their nonroutine contributions. Under P's transfer pricing method, P allocates the residual profit of \$120 (\$192 gross income minus \$12 salesperson commissions minus \$20 payment for back office services minus \$40 compensation for the routine contribution of acting as counterparty) using a multi-factor formula that reflects the relative value of the nonroutine contributions. Applying the comparability factors set out in § 1.482-8(a)(3), P allocates 40% of the residual profit to UKsub, 35% of the residual profit to P, and the remaining 25% of residual profit to Jsub. Accordingly, under step 2, \$48 is allocated to UKsub, \$42 is allocated to P, and \$30 is allocated to Jsub. See § 1.863-3(h) for the source of income allocated to P with respect to its counterparty function.

(f) **Unspecified methods.** Methods not specified in paragraphs (b), (c), (d), or (e) of this section may be used to evaluate whether the amount charged in a controlled transaction is at arm's length. Any method used under this paragraph (f) must be applied in accordance with the provisions of § 1.482-1 as modified by paragraph (a)(3) of this section.

(g) **Source rule for qualified business units.** See § 1.863-3(h) for application of the rules of this section for purposes of determining the source of income, gain or loss from a global dealing operation among qualified business units (as defined in section 989(c) and §§ 1.863-3(h)(3)(iv) and 1.989(a)-1).

Par. 7. Section 1.863-3 is amended as follows:

1. Paragraph (h) is redesignated as paragraph (i).

2. A new paragraph (h) is added. The addition reads as follows:

§ 1.863-3 Allocation and apportionment of income from certain sales of inventory.

* * * * *

(h) **Income from a global dealing operation—(1) Purpose and scope.** This paragraph (h) provides rules for sourcing income, gain and loss from a global dealing operation that, under the rules of § 1.482-8, is earned by or allocated to a controlled taxpayer qualifying as a participant in a global dealing operation under § 1.482-8(a)(2)(ii). This paragraph (h) does not apply to income earned by or allocated to a controlled taxpayer qualifying as a participant in a global dealing operation that is specifically sourced under sections 861, 862 or 865, or to substitute payments earned by a participant in a global dealing operation that are sourced under § 1.861-2(a)(7) or § 1.861-3(a)(6).

(2) **In general.** The source of any income, gain or loss to which this section applies shall be determined by reference to the residence of the participant. For purposes of this paragraph (h), the residence of a participant shall be determined under section 988(a)(3)(B).

(3) **Qualified business units as participants in global dealing operations—(i) In general.** Except as otherwise provided in this paragraph (h), where a single controlled taxpayer conducts a global dealing operation through one or more qualified business units (QBUs), as defined in section 989(a) and § 1.989(a)-1, the source of income, gain or loss generated by the global dealing operation and earned by or allocated to the controlled taxpayer shall be determined by applying the rules of § 1.482-8 as if each QBU that performs activities of a regular dealer in securities as defined in § 1.482-8(a)(2)(ii)(A) or the related activities described in § 1.482-8(a)(2)(ii)(B) were a separate controlled taxpayer qualifying as a participant in the global dealing operation within the meaning of § 1.482-8(a)(2)(ii). Accordingly, the amount of income sourced in the United States and outside of the United States shall be determined by treating the QBU as a participant in the global dealing operation, allocating income to each participant under § 1.482-8, as modified by paragraph (h)(3)(ii) of this section, and sourcing the income to the United States or outside of the United States under § 1.863-3(h)(2).

(ii) **Economic effects of a single legal entity.** In applying the principles of § 1.482-8, the taxpayer shall take into account the economic effects of conducting a global dealing operation through a single entity instead of multiple legal entities. For example,

since the entire capital of a corporation supports all of the entity's transactions, regardless of where those transactions may be booked, the payment of a guarantee fee within the entity is inappropriate and will be disregarded.

(iii) *Treatment of interbranch and interdesk amounts.* An agreement among QBUs of the same taxpayer to allocate income, gain or loss from transactions with third parties is not a transaction because a taxpayer cannot enter into a contract with itself. For purposes of this paragraph (h)(3), however, such an agreement, including a risk transfer agreement (as defined in § 1.475(g)-2(b)) may be used to determine the source of global dealing income from transactions with third parties in the same manner and to the same extent that transactions between controlled taxpayers in a global dealing operation may be used to allocate income, gain or loss from the global dealing operation under the rules of § 1.482-8.

(iv) *Deemed QBU.* For purposes of this paragraph (h)(3), a QBU shall include a U.S. trade or business that is deemed to exist because of the activities of a dependent agent in the United States, without regard to the books and records requirement of § 1.989(a)-1(b).

(v) *Examples.* The following examples illustrate this paragraph (h)(3).

Example 1. Use of comparable uncontrolled financial transactions method to source global dealing income between branches. (i) F is a foreign bank that acts as a market maker in foreign currency through branch offices in London, New York, and Tokyo. In a typical business day, the foreign exchange desk in F's U.S. branch (USFX) enters into several hundred spot and forward contracts on the interbank market to purchase and sell Deutsche marks (DM) with unrelated third parties. Each of F's branches, including USFX, employs both marketers and traders for their foreign currency dealing. In addition, USFX occasionally transfers risk with respect to its third party DM contracts to F's London and Tokyo branches.

These interbranch transfers are entered into in the same manner as trades with unrelated third parties. On a typical day, risk management responsibility for no more than 10% of USFX's DM trades are transferred interbranch. F records these transfers by making notations on the books of each branch that is a party to the transfers. The accounting procedures are nearly identical to those followed when a branch enters into an offsetting hedge with a third party. USFX maintains contemporaneous records of its interbranch transfers and third party transactions, separated according to type of trade and counterparty. Moreover, the volume of USFX's DM spot purchases and sales each day consistently provides USFX with third party transactions that are contemporaneous with the transfers between the branches.

(ii) As provided in paragraph (h)(3)(i) of this section, USFX and F's other branches that trade DM are participants in a global dealing operation. Accordingly, the principles of § 1.482-8 apply in determining the source of income earned by F's qualified business units that are participants in a global dealing operation. Applying the comparability factors in § 1.482-8(a)(3) shows that USFX's interbranch transfers and uncontrolled DM-denominated spot and forward contracts have no material differences. Because USFX sells DM in uncontrolled transactions and transfers risk management responsibility for DM-denominated contracts, and the uncontrolled transactions and interbranch transfers are consistently entered into contemporaneously, the interbranch transfers provide a reliable measure of an arm's length allocation of third party income from F's global dealing operation in DM-denominated contracts. This allocation of third party income is treated as U.S. source in accordance with §§ 1.863-3(h) and 1.988-4(h) and accordingly will be treated as income effectively connected with F's U.S. trade or business under § 1.864-4.

Example 2. Residual profit split between branches. (i) F is a bank organized in country X that has a AAA credit rating and engages in a global dealing operation in foreign currency options through branch offices in London, New York, and Tokyo. F has dedicated marketers and traders in each branch who work closely together to design and sell foreign currency options that meet the particular needs of customers. Each branch also employs general salespeople who sell standardized foreign currency options, as well as other financial products and foreign currency offered by F. F's traders work from a common book of transactions that is risk managed at each branch during local business hours. Accordingly, all three branches share the responsibility for risk managing the book of products. Personnel in the home office of F process and confirm trades, reconcile trade tickets, and provide ongoing administrative support (back office services) for the other branches. The global dealing operation has generated \$223 of operating profit for the period.

(ii) Under § 1.863-3(h), F applies § 1.482-8 to allocate global dealing income among its branches, because F's London, New York, and Tokyo branches are treated as participants in a global dealing operation that deals in foreign currency options under § 1.482-8(a)(2). After analyzing the foreign currency options business, F has determined that the residual profit split method is the best method to determine an arm's length amount of compensation allocable to each participant in the global dealing operation.

(iii) Under the first step of the residual profit split method (§ 1.482-8(e)(6)(ii)), F identifies and compensates the routine contributions performed by each participant. F determines that an arm's length compensation for general salespeople is \$3, \$4, and \$5 in New York, London, and Tokyo, respectively, and that the home office incurred \$11 of expenses in providing the back office services. Since F's capital legally supports all of the obligations of the branches, no amount is allocated to the home office of F for the provision of capital.

(iv) The second step of the residual profit split method (§ 1.482-8(e)(6)(iii)) requires that the residual profit be allocated to participants according to their nonroutine contributions. F determines that a multi-factor formula best reflects these contributions. After a detailed functional analysis, and applying the comparability factors in § 1.482-8(a)(3), 40% of the residual profit is allocated to the London branch, 35% to the New York branch, and the remaining 25% to the Tokyo branch. Thus, the residual profit of \$200 (\$223 operating profit minus \$12 general salesperson commissions minus \$11 back office allocation) is allocated \$80 to London (40% allocation×\$200), \$70 to New York (35%×\$200) and \$50 to Tokyo (25%×\$200).

Example 3. Residual profit split—deemed branches. (i) P, a U.K. corporation, conducts a global dealing operation in notional principal contracts, directly and through a U.S. subsidiary (USSub) and a Japanese subsidiary (Jsub). P is the counterparty to all transactions entered into with third parties. P, USSub, and Jsub each employ marketers and traders who work closely together to design and sell derivative products to meet the particular needs of customers. USSub also employs personnel who process and confirm trades, reconcile trade tickets and provide ongoing administrative support (back office services) for the global dealing operation. The global dealing operation maintains a single common book for each type of risk, and the book is maintained where the head trader for that type of risk is located. However, P, USSub, and Jsub have authorized a trader located in each of the other affiliates to risk manage its books during periods when the primary trading location is closed. This grant of authority is necessary because marketers, regardless of their location, are expected to sell all of the group's products, and need to receive pricing information with respect to products during their clients business hours, even if the booking location is closed. The global dealing operation has generated \$180 of operating profit for the period.

(ii) Because employees of USSub have authority to enter into contracts in the name of P, P is treated as being engaged in a trade or business in the United States through a deemed QBU. § 1.863-3(h)(3)(iv). Similarly, under U.S. principles, P would be treated as being engaged in business in Japan through a QBU. Under § 1.482-8(a)(2), P, USSub, and Jsub are participants in the global dealing operation relating to notional principal contracts. Additionally, under § 1.863-3(h)(3), the U.S. and Japanese QBUs are treated as participants in a global dealing operation for purposes of sourcing the income from that operation. Under § 1.863-3(h), P applies the methods in § 1.482-8 to determine the source of income allocated to the U.S. and non-U.S. QBUs of P.

(iii) After analyzing the notional principal contract business, P has concluded that the residual profit split method is the best method to allocate income under § 1.482-8 and to source income under § 1.863-3(h).

(iv) Under the first step of the residual profit split method (§ 1.482-8(e)(6)(ii)), P identifies and compensates the routine contributions performed by each participant.

Although the back office function does not give rise to participant status, in the context of a residual profit split allocation, the back office function is relevant for purposes of receiving remuneration for a routine contribution to a global dealing operation. P determines that an arm's length compensation for the back office is \$20. Since the back office services constitute a routine contribution, \$20 of income is allocated to USsub under step 1 of the residual profit split method. Similarly, as the arm's length compensation for the risk to which P is subject as counterparty is \$40, \$40 is allocated to P as compensation for acting as counterparty.

(v) The second step of the residual profit split method (§ 1.482-8(e)(6)(iii)) requires that the residual profit be allocated to participants according to the relative value of their nonroutine contributions. Under P's transfer pricing method, P allocates the residual profit of \$120 (\$180 gross income minus \$20 for back office services minus \$40 compensation for the routine contribution of acting as counterparty) using a multi-factor formula that reflects the relative value of the nonroutine contributions. Applying the comparability factors set out in § 1.482-8(a)(3), P allocates 40% of the residual profit to P, 35% of the residual profit to USsub, and the remaining 25% of residual profit to Jsub. Accordingly, under step 2, \$48 is allocated to P, \$42 is allocated to USsub, and \$30 is allocated to Jsub. Under § 1.863-3(h), the amounts allocated under the residual profit split is sourced according to the residence of each participant to which it is allocated.

(vi) Because the \$40 allocated to P consists of compensation for the use of capital, the allocation is sourced according to where the capital is employed. Accordingly, the \$40 is sourced 35% to P's deemed QBU in the United States under § 1.863-3(h)(3)(iv) and 65% to non-U.S. sources.

* * * * *

Par. 8. Section 1.863-7(a)(1) is amended by revising the second sentence to read as follows:

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

(a) *Scope—(1) Introduction.* * * * This section does not apply to income from a section 988 transaction (as defined in section 988(c) and § 1.988-1(a)), or to income from a global dealing operation (as defined in § 1.482-8(a)(2)(i)) that is sourced under the rules of § 1.863-3(h). * * *

* * * * *

Par. 9. Section 1.864-4 is amended as follows:

1. Paragraphs (c)(2)(iv), (c)(2)(v), (c)(3)(ii), and (c)(5)(vi)(a) and (b) are redesignated as (c)(2)(v), (c)(2)(vi), (c)(3)(iii), and (c)(5)(vi) (b) and (c), respectively.

2. New paragraphs (c)(2)(iv), (c)(3)(ii), and (c)(5)(vi)(a) are added.

The additions read as follows:

§ 1.864-4 U.S. source income effectively connected with U.S. business.

* * * * *

(c) * * *

(2) * * *

(iv) *Special rule relating to a global dealing operation.* An asset used in a global dealing operation, as defined in § 1.482-8(a)(2)(i), will be treated as an asset used in a U.S. trade or business only if and to the extent that the U.S. trade or business is a participant in the global dealing operation under § 1.863-3(h)(3), and income, gain or loss produced by the asset is U.S. source under § 1.863-3(h) or would be treated as U.S. source if § 1.863-3(h) were to apply to such amounts.

* * * * *

(3) * * *

(ii) *Special rule relating to a global dealing operation.* A U.S. trade or business shall be treated as a material factor in the realization of income, gain or loss derived in a global dealing operation, as defined in § 1.482-8(a)(2)(i), only if and to the extent that the U.S. trade or business is a participant in the global dealing operation under § 1.863-3(h)(3), and income, gain or loss realized by the U.S. trade or business is U.S. source under § 1.863-3(h) or would be treated as U.S. source if § 1.863-3(h) were to apply to such amounts.

* * * * *

(5) * * *

(vi) * * *

(a) *Certain income earned by a global dealing operation.* Notwithstanding paragraph (c)(5)(ii) of this section, U.S. source interest, including substitute interest as defined in § 1.861-2(a)(7), and dividend income, including substitute dividends as defined in § 1.861-3(a)(6), derived by a participant in a global dealing operation, as defined in § 1.482-8(a)(2)(i), shall be treated as attributable to the foreign corporation's U.S. trade or business, only if and to the extent that the income would be treated as U.S. source if § 1.863-3(h) were to apply to such amounts.

Par. 10. Section 1.864-6 is amended as follows:

1. Paragraph (b)(2)(ii)(d)(3) and (b)(3)(ii)(c) are added.

2. Paragraph (b)(3)(i) is revised by adding a new sentence after the last sentence.

The additions and revision read as follows:

§ 1.864-6 Income, gain or loss attributable to an office or other fixed place of business in the United States.

* * * * *

(b) * * *

(2) * * *

(ii) * * *

(d) * * *

(3) *Certain income earned by a global dealing operation.* Notwithstanding paragraphs (b)(2)(ii) (a) or (b) of this section, foreign source interest, including substitute interest as defined in § 1.861-2(a)(7), or dividend income, including substitute dividends as defined in § 1.861-3(a)(6), derived by a participant in a global dealing operation, as defined in § 1.482-8(a)(2)(i) shall be treated as attributable to the foreign corporation's U.S. trade or business only if and to the extent that the income would be treated as U.S. source if § 1.863-3(h) were to apply to such amounts. * * *

(3) * * *

(i) * * * Notwithstanding paragraphs (b)(3)(i) (1) and (2) of this section, an office or other fixed place of business of a nonresident alien individual or a foreign corporation which is located in the United States and which is a participant in a global dealing operation, as defined in § 1.482-8(a)(2)(i), shall be considered to be a material factor in the realization of foreign source income, gain or loss, only if and to the extent that such income, gain or loss would be treated as U.S. source if § 1.863-3(h) were to apply to such amounts.

(ii) * * *

(c) *Property sales in a global dealing operation.* Notwithstanding paragraphs (b)(3)(ii)(a) or (b) of this section, personal property described in section 1221(1) and sold in the active conduct of a taxpayer's global dealing operation, as defined in § 1.482-8(a)(2)(i), shall be presumed to have been sold for use, consumption, or disposition outside of the United States only if and to the extent that the income, gain or loss to which the sale gives rise would be sourced outside of the United States if § 1.863-3(h) were to apply to such amounts.

Par. 11. Section 1.894-1 is amended as follows:

1. Paragraph (d) is redesignated as paragraph (e).

2. New paragraph (d) is added.

The addition reads as follows:

§ 1.894-1 Income affected by treaty.

* * * * *

(d) *Income from a global dealing operation.* If a taxpayer that is engaged in a global dealing operation, as defined in § 1.482-8(a)(2)(i), has a permanent establishment in the United States under the principles of an applicable U.S. income tax treaty, the principles of § 1.863-3(h), § 1.864-4(c)(2)(iv), § 1.864-4(c)(3)(ii), § 1.864-4(c)(5)(vi)(a) or § 1.864-6(b)(2)(ii)(d)(3) shall apply

for purposes of determining the income attributable to that U.S. permanent establishment.

* * * * *

Par. 12. Section 1.988-4 is amended as follows:

1. Paragraph (h) is redesignated as paragraph (i).

2. A new paragraph (h) is added. The addition and revision read as follows:

§ 1.988-4 Source of gain or loss realized on a section 988 transfer.

* * * * *

(h) *Exchange gain or loss from a global dealing operation.*

Notwithstanding the provisions of this section, exchange gain or loss derived by a participant in a global dealing operation, as defined in § 1.482-8(a)(2)(i), shall be sourced under the rules set forth in § 1.863-3(h).

* * * * *

Michael P. Dolan,

Deputy Commissioner of Internal Revenue.

[FR Doc. 98-5674 Filed 3-2-98; 1:50 pm]

BILLING CODE 4830-01-P

DEPARTMENT OF DEFENSE

Defense Logistics Agency

32 CFR Part 323

[Defense Logistics Agency Reg. 5400.21]

Defense Logistics Agency Privacy Program

AGENCY: Defense Logistics Agency, DoD.

ACTION: Proposed rule.

SUMMARY: The Defense Logistics Agency proposes to exempt a system of records identified as S500.60 CA, entitled 'DLA Complaint Program Records' from certain provisions of the Privacy Act. The exemptions are intended to increase the value of the system of records for law enforcement purposes, to comply with prohibitions against the disclosure of certain kinds of information, and to protect the privacy of individuals identified in the system of records.

DATES: Comments must be received on or before May 5, 1998, to be considered by this agency.

ADDRESSES: Send comments to the Privacy Act Officer, Defense Logistics Agency, ATTN: CAAR, 8725 John J. Kingman Road, Suite 2533, Fort Belvoir, VA 22060-6221.

FOR FURTHER INFORMATION CONTACT: Ms. Susan Salus at (703) 767-6183.

SUPPLEMENTARY INFORMATION: **Executive Order 12866.** It has been determined that this Privacy Act rule for the Department of Defense does not

constitute 'significant regulatory action'. Analysis of the rule indicates that it does not have an annual effect on the economy of \$100 million or more; does not create a serious inconsistency or otherwise interfere with an action taken or planned by another agency; does not materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof; does not raise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in Executive Order 12866.

Regulatory Flexibility Act. It has been determined that this Privacy Act rule for the Department of Defense does not have significant economic impact on a substantial number of small entities because it is concerned only with the administration of Privacy Act systems of records within the Department of Defense.

Paperwork Reduction Act. It has been determined that this Privacy Act rule for the Department of Defense imposes no information requirements beyond the Department of Defense and that the information collected within the Department of Defense is necessary and consistent with 5 U.S.C. 552a, known as the Privacy Act, and 44 U.S.C. Chapter 35.

This proposed rule would add an exempt Privacy Act system of records to the DLA inventory of systems of records. DLA operates a complaint system whereby individuals may report instances of suspected fraud, waste, or abuse; mismanagement; contract deviations, noncompliance, or improprieties; administrative misconduct; or adverse treatment under the complaint program. Allegations are investigated and appropriate corrections are instituted. The proposal to exempt the system reflects recognition that certain records in the system may be deemed to require protection from disclosure in order to protect confidential sources mentioned in the files and avoid compromising, impeding, or interfering with investigative and enforcement proceedings. The Director proposes to adopt these exemptions for the reasons provided.

List of Subjects in 32 CFR part 323

Privacy.

Accordingly, 32 CFR part 323 is proposed to be amended as follows:

PART 323—DEFENSE LOGISTICS AGENCY PRIVACY PROGRAM.

1. The authority citation for part 323 continues to read as follows:

Authority: Pub. L. 93-579, 88 Stat 1896 (5 U.S.C. 552a).

2. Appendix H to Part 323 is proposed to be amended by adding paragraph e. as follows:

Appendix H to Part 323—DLA Exemption Rules.

* * * * *

e. *ID: S500.60 CA (Specific exemption).*

1. *System name:* DLA Complaint Program Records.

2. *Exemption:* (i) Investigatory material compiled for law enforcement purposes may be exempt pursuant to 5 U.S.C. 552a(k)(2). However, if an individual is denied any right, privilege, or benefit for which he would otherwise be entitled by Federal law or for which he would otherwise be eligible, as a result of the maintenance of the information, the individual will be provided access to the information except to the extent that disclosure would reveal the identity of a confidential source.

(ii) Investigatory material compiled solely for the purpose of determining suitability, eligibility, or qualifications for federal civilian employment, military service, federal contracts, or access to classified information may be exempt pursuant to 5 U.S.C. 552a(k)(5), but only to the extent that such material would reveal the identity of a confidential source.

3. *Authority:* 5 U.S.C. 552a(k)(2) and (k)(5), subsections (c)(3), (d)(1) through (d)(4), (e)(1), (e)(4)(G), (H), and (I), and (f).

4. *Reasons:* (i) From subsection (c)(3) because to grant access to an accounting of disclosures as required by the Privacy Act, including the date, nature, and purpose of each disclosure and the identity of the recipient, could alert the subject to the existence of the investigation or prosecutive interest by DLA or other agencies. This could seriously compromise case preparation by prematurely revealing its existence and nature; compromise or interfere with witnesses or make witnesses reluctant to cooperate; and lead to suppression, alteration, or destruction of evidence.

(ii) From subsections (d)(1) through (d)(4), and (f) because providing access to records of a civil or administrative investigation and the right to contest the contents of those records and force changes to be made to the information contained therein would seriously interfere with and thwart the orderly and unbiased conduct of the investigation and impede case preparation. Providing access rights normally afforded under the Privacy Act