ISDA Releases New Protocol to Address US Federal Withholding and Related Tax Issues

On August 23, 2010, the International Swaps and Derivatives Association, Inc. (ISDA) released a new protocol to certain ISDA 1992 and 2002 Master Agreements (Protocol). This Protocol provides parties to these agreements with a potential method for dealing with the US federal withholding tax provisions promulgated under the Hiring Incentives to Restore Employment Act (HIRE Act), which provisions become effective as early as September 14, 2010, as well as certain corollary matters. Most notably, the Protocol overrides the general requirement that payors gross up payees for any withholding taxes when the withholding is on certain "dividend equivalent" payments subject to the provisions of the HIRE Act and allows parties to terminate their agreements if such withholding cannot be avoided.

Imposition of US Federal Tax Withholding on "Dividend Equivalent" Payments Under the HIRE Act

Under current US tax law, payments of interest, dividends and other types of fixed, determinable, annual, or periodical income from US sources to non-US persons generally are subject to 30 percent US withholding tax. The requirement to withhold is subject to certain exemptions and may be reduced under an applicable tax treaty or otherwise.

As a general rule, US tax law sources dividends according to the residence of the payor, such that dividends paid by a US corporation generally constitute US-source payments regardless of whether the recipient is a US or a non-US person. However, in the context of a swap, payments are treated as being made under a notional principal contract (NPC) for US federal withholding tax purposes and, as such, are sourced according to the recipient's residence. This rule results in payments referencing the stock of a US corporation under an NPC being treated as foreign-source for US federal withholding tax purposes when the recipient is a non-US person. Thus, such payments are exempt from US federal withholding tax.

To deal with this incongruity in treatment, the HIRE Act requires US federal tax withholding on "dividend equivalent" payments made under certain NPCs by treating those payments

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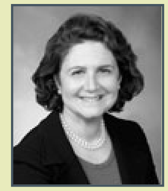

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as payments of dividends from US sources. Notably, when calculating the net payments which are actually made under the applicable NPC, parties will need to apply the US federal withholding tax to the gross payment amount used to calculate the net payments.

A "dividend equivalent" payment is any payment made pursuant to a "specified NPC" that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States. For two years from the date of the enactment of the HIRE Act, an NPC is a "specified NPC" if it has at least one of the following characteristics:

1. In connection with entering into an NPC, any long party to the NPC transfers the underlying security to any short party to the NPC;
2. In connection with the termination of an NPC, any short party to the NPC transfers the underlying security to any long party to the NPC;
3. The underlying security is not readily tradable on an established securities market;
4. In connection with entering into an NPC, any short party to the NPC posts the underlying security as collateral with any long party to the NPC; or
5. The NPC is otherwise identified by the Secretary of the Treasury as a specified NPC.

After the initial two-year period, "dividend equivalent" payments made under all NPCs will be treated as "specified NPCs" and thus will come within the scope of the above-described withholding rules, unless the US Department of the Treasury issues regulations exempting any particular swaps from this withholding requirement.

Impact of the HIRE Act "Dividend Equivalent" Payment Provisions on Parties to ISDA Master Agreements

As a general rule, ISDA Master Agreements require that, in the event a payor must withhold on payments it makes, such payor must make the recipient whole by "grossing up" the payment so that the recipient receives the same amount such recipient would have received if no withholding had been deducted from the payment. This means that, absent additional guidance, the application of the HIRE Act withholding provisions to "dividend equivalent" payments would force payors to gross up "dividend equivalent" payments they make pursuant to specified NPCs.

However, to the extent provided for under a specific ISDA Master Agreement, a payor may be able to claim that the HIRE Act provisions constitute a change in law, which would relieve the payor from the duty to withhold on payments it makes. The utility of this argument is limited in an important respect. While parties to swaps in place before March 18, 2010 may be able to take advantage of this argument, parties to swaps entered into after that date cannot invoke the change in law provision to claim relief because the law, although generally not effective until September 14, 2010, has been known to such parties since its enactment on March 18, 2010.

ISDA's Response to the HIRE Act Provisions

The Protocol offers a more complete solution to the gross-up requirements than the change in law solution described above. The protocol specifically stipulates that US federal tax withholding imposed under the HIRE Act is exempted from the general gross-up provisions. The Protocol's scope appropriately extends to and provides the mechanics for dealing with situations in which withholding is required even if the net payment made by a party is not proportionate in size to the amount of withholding required (for instance, where the withholding remitted directly to the US Internal Revenue Service is greater than the net payment to be made).

In addition, the Protocol includes certain new representations relevant to the HIRE Act. Specifically, with respect to payments made on or after September 14, 2010, a payee receiving a "dividend equivalent" payment must represent that the nature of the transaction is not one that would require US federal withholding (for example, by meeting the definition of a "specified NPC," as described above). With respect to payments made after December 31, 2012, both the payor and the payee must represent that the payee will meet the necessary US Internal Revenue Service information reporting requirements so as to preclude the need for the payor to withhold on payments. This representation effectively puts the responsibility for the US federal withholding tax on the payee by putting the payee in control of whether the reporting requirements are satisfied. While the Protocol assigns the responsibility for any withholding taxes that may arise from the failure to comply with the reporting requirements, uncertainty remains because specific reporting requirements have yet to be identified by the US government.

The Protocol addresses other related issues, such as the potential reduction of the withholding tax rate on "dividend equivalent" payments under an applicable tax treaty and, in response to the US Internal Revenue Service's aggressive audit activity toward US payors under swap agreements, the ability of such payors to terminate those agreements.

With respect to the former, the Protocol expands the list of treaty provisions for which a party may be eligible to include the "dividends" article. With respect to the latter, the Protocol revises the definition of a "tax event" to permit a US payor to terminate a swap if there is a "substantial likelihood" that such payor would be required to gross up future payments "due to" an "action taken by a taxing authority," provided that certain documentation requirements are satisfied.

Lastly, the Protocol permits parties unilaterally to terminate a swap agreement if "dividend equivalent" payments thereunder become subject to US federal tax withholding as a result of the application of the HIRE Act provisions. The Protocol prescribes the mechanism for effecting such termination rights.

The Protocol generally is effective as of the date it is entered into by both parties and applies to transactions that are outstanding on or entered into after that date. However, other effective dates apply in connection with certain specified aspects of the Protocol. Specifically, the clarification of a "tax event" for purposes of terminating an agreement is applicable only to transactions entered into after the Protocol becomes effective between the parties. In addition, the new payee representations are effective only after September 13, 2010 and apply to transactions entered into or outstanding after that date.

We hope that you have found this advisory useful. If you have any questions, please contact your Arnold & Porter attorney or:

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