CADWALADER

Cadwalader, Wickersham & Taft LLP
New York London Charlotte Washington Beijing

One World Financial Center, New York, NY 10281
Tel 212 504 6000 Fax 212 504 6666
www.cadwalader.com

Clients&FriendsMemo

The Hiring Incentives to Restore Employment Act

March 22, 2010

I. Introduction

On Thursday, March 18, President Obama signed into law H.R. 2847, the Hiring Incentives to Restore Employment Act (the "Act" or the "HIRE Act"). The Act provides incentives for the creation of jobs, primarily by providing tax breaks to companies that hire unemployed workers, extending current highway programs, and allowing increased expensing for capital investments made by small businesses. The Act offsets the cost of these expenditures principally with three revenue raising tax provisions: an enhanced foreign reporting regime, the imposition of U.S. withholding tax on certain equity swaps, and a delay of implementation of the worldwide allocation of interest election until January 1, 2021. The enhanced foreign reporting regime and the imposition of U.S. withholding tax on certain equity swaps were originally introduced in the Foreign Account Tax Compliance Act of 2009 or "FATCA" (discussed here) and reintroduced in the Tax Extenders Act of 2009 (discussed here).

II. Summary

1. Enhanced Reporting and Withholding Regime

Beginning in 2013, the Act generally requires foreign investment banks, foreign commercial banks, foreign insurance companies, foreign hedge funds and private equity funds, foreign securitization vehicles, and other "foreign financial institutions" to enter into an agreement with the U.S. Treasury Department that will require them to obtain the name, address, taxpayer identification number and certain other information with respect to any direct or indirect United States "account holder" (which includes direct and indirect United States holders of non-publicly-traded equity or debt in the foreign financial institution) and report this information to the IRS. Any "recalcitrant" United States account holder that fails to provide the information will be subject to a 30% withholding tax on their share of any U.S.-source dividend, interest, rents, and certain other payments, and the proceeds of the sale of U.S. stocks and debt instruments. In the absence of regulations, any amounts withheld with respect to a foreign financial institution that is the beneficial owner of a payment will not be refundable or creditable unless the foreign financial institution is entitled to the benefits of a tax treaty with the United States.

This memorandum has been prepared by Cadwalader, Wickersham & Taft LLP for informational purposes only and does not constitute advertising or solicitation and should not be used or taken as legal advice. Those seeking legal advice should contact a member of the Firm or legal counsel licensed in their state. Transmission of this information is not intended to create, and receipt does not constitute, an attorney-client relationship. Confidential information should not be sent to Cadwalader, Wickersham & Taft LLP without first communicating directly with a member of the Firm about establishing an attorney-client relationship.

Beginning in 2013, the Act also generally requires certain other (non-financial) foreign entities to obtain and disclose the name, address, and taxpayer identification number of any United States person that owns directly or indirectly 10% of the vote or value of any of its stock (for a corporation), 10% of its profits or capital (in the case of a partnership), 10% of the beneficial interests (for a trust), or any United States person that owns an equity interest in the foreign entity through a foreign investment or trading vehicle. If the non-financial foreign entity fails to disclose any of these United States persons, the foreign entity will be subject to a 30% withholding tax with respect to all U.S.-source dividend, interest, rents, and certain other payments, and 30% of the proceeds from the sale of any U.S. stock or debt securities.

These reporting and withholding requirements were originally introduced in the FATCA bill and are often referred to as the "FATCA reporting requirements."

2. U.S. Withholding Tax on U.S.-Source Interest Paid on Bearer Bonds

The Act imposes a 30% U.S. withholding tax on U.S.-source interest payments on most bearer bonds issued after March 18, 2012.

3. 30% U.S. Withholding on Substitute Dividend Payments on Certain Equity Swaps

Beginning September 14, 2010, any payment to a foreign counterparty on an equity swap (or any substantially similar payment on any financial instrument) that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a U.S.-source dividend will be subject to a 30% U.S. withholding tax if (i) the foreign counterparty transferred the underlying stock to its counterparty in connection with the transaction (i.e., the underlying stock "crossed in"), (ii) the counterparty transfers the underlying stock to the foreign counterparty at the termination of the transaction (i.e., the underlying stock "crosses out"), (iii) the underlying stock is not readily tradable on an established securities market, (iv) the underlying stock is posted as collateral to the foreign party, or (v) the equity swap or other transaction is otherwise identified by Treasury as subject to withholding.

Moreover, beginning September 14, 2010, a 30% U.S. withholding tax will be imposed on any payment made to a foreign party pursuant to a securities lending or sale-repurchase transaction (or any substantially similar payment on another financial instrument) that (directly or indirectly) is contingent upon, or determined by reference to the payment of a U.S.-source dividend.

Beginning March 18, 2012, a 30% U.S. withholding tax will be imposed on any payment made to any foreign party on an equity swap (or any substantially similar financial instrument) that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a U.S.-source

dividend, except to the extent that regulations are issued that provide that the notional principal contract (or other financial instrument) does not have the potential for tax avoidance.

It is anticipated that regulations will be issued before March 18, 2012 that will provide that dividend equivalent payments on certain equity swaps and other financial instruments will not be subject to U.S. withholding tax.

Part III of this memorandum discusses the FATCA reporting and withholding requirements, the imposition of U.S. withholding tax on U.S.-source interest income on bearer bonds, and certain additional reporting requirements imposed under the Act. Part IV of this memorandum discusses withholding on dividend equivalent payments under equity swaps.

4. Delay of the Worldwide Allocation of Interest Election Until 2021

The American Jobs Creation Act of 2004 provided a one-time election, effective beginning in 2009, that would allow taxpayers to allocate interest expense between United States sources and foreign sources on a worldwide basis (as if all members of a worldwide group were members of a single corporation) for purposes of determining a taxpayer's foreign tax credit limitation. This provision was delayed until 2017 under the Worker, Homeownership, and Business Assistance Act of 2009, and the Act further delays the election until January 1, 2021. This memorandum does not otherwise discuss the delay of the worldwide allocation of interest election.

5. Foreign Trust Provisions

The HIRE Act also expands the definition of a U.S. beneficiary of a foreign trust, which will have the effect of requiring certain U.S. persons that transfer property to a foreign trust to report the income from the trust. The Act also treats the loan of certain property by a foreign trust to a U.S. person as a distribution, and requires additional reporting by the U.S. owner of a grantor trust. This memorandum does not discuss the trust provisions of the Act.

III. The "FATCA" Reporting and Withholding Requirements

A. Enhanced Foreign Reporting

1. *Rules for "Foreign Financial Institutions."* The Act generally imposes a 30% withholding tax on U.S.-source interest, dividends, rents and other "fixed or determinable, annual or periodical" income, and the gross proceeds from the sale or other disposition of any property that produces U.S.-source interest or dividends (e.g., stock or debt of a U.S. corporation), paid to a "foreign financial institution," unless the foreign financial institution enters into an agreement with the U.S. Treasury Department to provide certain information with

respect to United States persons that hold depositary and custodial accounts at the institution, and equity and debt of the foreign financial institution (other than equity or debt that is regularly traded on an established securities market).[1]

For these purposes, a foreign financial institution is defined broadly to include any foreign entity that (i) accepts deposits in the ordinary course of a banking or similar business, (ii) holds financial assets for the account of others as a substantial portion of its business, or (iii) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting or trading in financial assets (including securities, partnership interests, commodities, or any interest in such securities, partnership interests or commodities). Therefore, in addition to foreign investment and commercial banks and foreign insurance companies, most foreign hedge funds, foreign "blocker corporations," foreign collateral debt obligation issuers, foreign private equity funds, and other foreign securitization vehicles are treated as "foreign financial institutions" that must enter into an agreement with the U.S. Treasury Department or be subject to withholding on certain U.S.-source payments and the gross proceeds from the sales of U.S. equity and debt securities.[2]

We expect that foreign investment and commercial banks, foreign hedge funds, and other foreign financial institutions that could directly or indirectly receive U.S.-source income or the proceeds from the sale of U.S. securities will enter into agreements with the U.S. Treasury Department.

The agreement with the U.S. Treasury Department will require the foreign financial institution to identify each depository or custodial account, and each equity or debt interest (other than interests that are regularly traded on an established securities market), held by:

- a "United States person,"[3] unless each holder of the account is a natural person and the aggregate value of all depository accounts held by each holder and maintained by the foreign financial institution does not exceed $50,000,

---

[1] No withholding is imposed on payments to a foreign financial institution that fails to enter into an agreement with the U.S. Treasury Department if the beneficial owner of the payment is (i) a foreign government, political subdivision of a foreign government, or any wholly owned agency or instrumentality of either of the foregoing, (ii) an international organization or its wholly owned agency or instrumentality, (iii) a foreign central bank of issue, or (iv) any other class of persons that the IRS identifies as posing a low risk of tax evasion.

[2] Any foreign financial institution that is more than 50% owned by a foreign financial institution or is greater than 50% commonly owned with the financial institution is considered part of the "expanded affiliate group" as the foreign financial institution and is subject to the same reporting and withholding requirements. Thus, if a foreign financial institution enters into an agreement with the U.S. Treasury Department, all other foreign financial institutions that are also members of the expanded affiliate group are required to comply with the agreement.

[3] A United States person is defined as (i) a citizen or resident of the United States for U.S. federal income tax purposes, (ii) a partnership organized under the laws of the United States or any state, (iii) a corporation organized under the laws of the United States or any state, (iv) an estate the income of which is subject to U.S. federal income tax regardless of the source,

- a foreign entity that is treated as a corporation for U.S. tax purposes in which a United States person owns more than 10% of the stock by vote or value,
- a foreign entity that is treated as a partnership for U.S. tax purposes in which a United States person owns 10% of the profits or capital interest,
- a foreign entity that is treated as a grantor trust for U.S. tax purposes if a United States person is treated as an owner,
- to the extent provided in Treasury regulations or other IRS guidance, a foreign entity that is treated as a foreign trust for U.S. federal income tax purposes, if a United States person is the beneficial owner of more than 10% of any portion of its assets,
- a foreign entity that is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, interests in partnerships, or commodities and in which any United States person owns any interest.

The foreign entities in these bullets are referred to as "United States owned foreign entities" and the ultimate United States owners of these entities are referred to as "substantial United States owners" of a United States owned foreign entity.

The foreign financial institution must agree to report to the IRS the name, address, and taxpayer identification number, and account balance or value and account number, and (except to the extent provided by the IRS) the gross receipts and withdrawals for the account for each United States person and any substantial United States owner of a United States owned foreign entity that directly or indirectly holds a custodial or depositary account or nonpublicly-traded debt or equity in the foreign financial institution. The agreement with the U.S. Treasury Department will also require the foreign financial institution to comply with verification and due diligence procedures (including

---

or (v) a trust, if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more United States persons have the authority to control all substantial decisions of the trust. Section 7701(a)(30).

However, for these purposes, a United States person does not include (i) a publicly traded corporation, or a corporation that is a member of the publicly-traded corporation's "expanded affiliate group" (i.e., any corporation that is more than 50% owned by a publicly-traded corporation or is greater than 50% commonly owned with the publicly-traded corporation), (ii) a tax-exempt organization or an individual retirement plan, (iii) the United States, any State, the District of Columbia, any possession of the United States, or any political subdivision of any of the foregoing, or any wholly owned agency or instrumentality of any one or more of the foregoing, (iv) any bank (as defined in section 581), (v) a "real estate investment trust" or "regulated investment company," (vi) a common trust fund (as defined in section 584(a)), and (vii) a "charitable remainder trust" or a "charitable trust" described in section 4947(a)(1). Thus a foreign hedge fund will not be required to report information with respect to any REIT, mutual fund or IRA that holds an interest in it.

All references to section numbers are to the Internal Revenue Code of 1986, as amended (the "Code") , or the Treasury regulations issued thereunder, unless otherwise indicated.

know-your-customer, anti-money laundering, anti-corruption and similar rules), reporting requirements, and requests by the IRS for additional information. It will also require the institution to attempt to obtain a waiver in any case where foreign law would otherwise prevent the required reporting and, if the waiver is not obtained within a reasonable period of time, to close the account.[4]

If a foreign financial institution is unable to obtain the relevant information from the particular account holder (referred to as a "recalcitrant account holder"), pursuant to the agreement with the U.S. Treasury Department, the foreign financial institution must either (i) withhold 30% from any U.S.-source payment and 30% of the gross proceeds from the sale of any U.S. stock or debt instrument paid to the recalcitrant account holder or (ii) elect to receive its U.S.-source payments (including gross proceeds from sales of U.S. stock and debt) subject to 30% withholding on the portion that is allocable to the recalcitrant account holder.

We anticipate that most foreign commercial and investment banks, foreign insurance companies, foreign hedge funds and other foreign financial institutions will require all of their account holders, and the holders of their non-publicly-traded equity and debt, to certify whether they are a United States person or United States owned foreign entity and to provide the required information if they are. These disclosure and reporting requirements will affect all foreign entities that directly or indirectly hold an account, or nonpublicly-traded debt or equity, in any foreign entity that has itself entered into an agreement with the U.S. Treasury Department.

For example, assume that an offshore "fund-of-funds" hedge fund owns only interests in other offshore hedge funds that are treated as foreign corporations for U.S. tax purposes. This offshore fund-of-funds will not itself be required to enter into an agreement with the U.S. Treasury Department because it will not directly receive U.S.-source payments or the proceeds from the sale of U.S. stock or securities. However, if one of the underlying offshore hedge funds it owns receives U.S.-source payments, then the underlying hedge fund will be required to enter into an agreement with the U.S. Treasury Department and this underlying hedge fund will withhold on payments to the offshore fund-of-funds unless the fund-of-funds provides the requested information. Moreover, because the fund-of-funds is principally an investing or trading vehicle, it will be required to disclose information about <u>any</u> United States person that own <u>any</u> interest in it. In order to satisfy

---

[4] In lieu of these requirements, the foreign financial institution may make an election to be subject to all of the reporting and withholding rules that are applicable to U.S. persons (which would require the foreign financial institution to provide holders with Forms 1099).

The Act provides the IRS with authority to exempt certain institutions (and classes of institutions) from these requirements. The Joint Committee on Taxation explanation of the Act anticipates that certain widely held collective investment vehicles, certain controlled foreign corporations of U.S. financial institutions, and certain U.S. branches of foreign financial institutions may be exempt.

this requirement, it will be required to obtain certifications from all of the foreign holders of its equity because, if any of these holders are themselves investing or trading vehicles, they will have to disclose all of their equityholders that are United States persons.

The Act provides that a foreign financial institution need not report a United States account if that account is held by another foreign financial institution that itself satisfies the reporting requirements under the Act, or if the account holder is otherwise subject to information reporting that the U.S. Treasury Department determines would render the reporting by the foreign financial institution duplicative. Thus, if a foreign hedge fund has a foreign investor that itself has entered into an agreement with the U.S. Treasury Department, the foreign hedge fund would not be required to receive information about the foreign investor's investors that are United States persons.

If a foreign financial institution is the beneficial owner of a payment that is subject to withholding (either because a payment to the foreign financial institution is subject to withholding or because the foreign financial institution withholds from a recalcitrant account holder), then a refund is available only if the foreign financial institution is entitled to a reduced rate of tax under a tax treaty, and then only to the extent the refund is attributable to that reduced rate. Thus, if a foreign hedge fund (that is treated as a corporation and is not entitled to treaty benefits) inadvertently fails to enter into an agreement with the U.S. Treasury Department and consequently is subject to a 30% withholding tax on all of its U.S. source, dividends, interest and the proceeds from sales of U.S. stock and debt, a United States investor in a foreign hedge fund that has entered into such an agreement fails to provide the hedge fund with the necessary information, or a foreign investor in a foreign hedge fund that has entered into an agreement fails to certify to the hedge fund that it is not a United States person, then the fund and the investors will not be able to receive a refund under any circumstances. This provision will effectively subject recalcitrant United States account and equity holders and the equity owners of recalcitrant foreign hedge funds (and other foreign entities) to a withholding tax. The effect of this withholding tax may amount to a double tax in certain circumstances.[5]

2. *Rules for Foreign Non-Financial Entities.* The Act generally imposes a 30% withholding tax on U.S.-source interest, dividends, and other "fixed or determinable, annual or periodical" income, and on the gross proceeds from the sale or other disposition of U.S.

[5] Assume that a foreign hedge fund is organized as a partnership, has an investor who is a United States person, and fails to provide the required information. Assume further that the investor is allocated $100 of U.S.-source income and is subject to $30 of withholding. If the foreign hedge fund is treated as the beneficial owner of the payment, it appears that the investor would recognize $100 of income (even though the investor would receive only $70 after withholding). The investor may be entitled to a deduction of $30 but, if the investor is not engaged in a trade or business, the deduction may be a miscellaneous itemized deduction that the investor is unable to use. In this case, the investor would effectively bear double tax. It is possible that regulations could provide under these facts that the investor is treated as the beneficial owner of the payment, which would permit the United States person to receive credit for the withholding.

stocks and debt instruments paid to a foreign "non-financial" institution (i.e., a foreign entity that is not a foreign financial institution) unless the foreign entity provides the name, address, and taxpayer identification number of each of its substantial owners that are United States persons.[6]

If a foreign non-financial institution is unable to obtain information about a substantial equity owner (i.e., there is a "recalcitrant equity owner"), the foreign non-financial institution will be subject to a 30% withholding tax on the entire payment, and not only on the portion allocable to the recalcitrant holder. However, any foreign entity that is not a foreign financial institution will generally be entitled to a refund of deducted and withheld amounts that are determined to have been overpaid, if the foreign entity provides the IRS with information necessary to determine whether one or more United States persons are substantial owners of the foreign beneficial owner and the identity of the substantial United States owners.

3. *Exemptions From Withholding*. Payments to the following entities and institutions are exempt from withholding under the Act:

- a publicly traded corporation, or a member of the "expanded affiliated group" of a publicly traded corporation,[7]
- an entity organized under the laws of a possession of the United States that is wholly owned by one or more bona fide residents of such possession,[8]
- a foreign government, any political subdivision of a foreign government, or any wholly owned agency or instrumentality of a foreign government or its political subdivision,
- an international organization or any wholly owned agency or instrumentality of an international organization,
- any foreign central bank of issue, or
- any other class of persons identified by the IRS for purposes of the provision.

---

[6] A substantial United States owner of a foreign non-financial institution generally includes 10% U.S. owners (*i.e.*, corresponding to the second-fifth bullets in Part III.A.1, above).

[7] An "expanded affiliated group" for these purposes is generally defined as one or more chains of corporations more than 50% owned (by vote or value) by a common parent corporation or which share greater than 50% common ownership (by vote or value).

[8] A bona fide resident of a possession is defined as a person (i) who is present for at least 183 days during the taxable year in Guam, American Samoa, the Northern Mariana Islands, Puerto Rico, or the U.S. Virgin Islands, and (ii) who does not have a tax home outside the possession during the taxable year and does not have a closer connection to the United States or a foreign country than to the possession.

The IRS also has the authority to exempt an entire class of payments from withholding if the class of payment poses a low risk of tax evasion.

B. Imposition of Withholding Tax on U.S.-Source Interest Paid on Most Bearer Bonds

Under the Act, a 30% withholding tax will apply to U.S.-source interest income paid on most bearer bonds issued after March 18, 2012 unless the obligation is (1) issued by a natural person, (2) matures in one year or less, or (3) is not of a type offered to the public. (Thus, U.S.-source interest paid on outstanding bearer bonds and bearer bonds issued for the next two years will continue to be exempt from U.S. withholding to the extent provided under current law.) The Act provides that a debt obligation held through a "dematerialized" book entry system (such as in Japan), or other book entry system specified by the IRS, will be treated as issued in registered — and not bearer — form for U.S. federal tax purposes, and will thus not be subject to U.S. withholding tax.

C. Disclosure of Foreign Financial Assets To Be Filed with Tax Return

For taxable years beginning in 2011, the Act requires U.S. individuals to file an annual information report listing any interest they hold in a foreign financial account (including non-publicly-traded equity and debt of a foreign financial institution), any stock or security issued by a foreign person, any interest in a foreign entity, or any financial instrument or contract issued by a foreign person and held for investment, if the aggregate value of all such accounts, entities, instruments and/or contracts exceeds $50,000.[9] (An asset is presumed to exceed $50,000 unless the individual provides the IRS with enough information to determine its value.) This requirement is in addition to the requirements imposed on United States persons to file Foreign Bank and Financial Account Reports ("FBARs") on a Form TD F 90-22.1 (discussed here).

The penalty for failure to disclose is $10,000 and increases up to $50,000 if the failure is not corrected within 90 days following notification from the IRS. Moreover, for taxable years beginning in 2011, the Act imposes a 40% accuracy-related penalty (in place of the 20% accuracy-related penalty imposed under current law) for any understatement of tax liability attributable to any foreign financial asset that was required to be reported to the IRS, but was not.[10]

---

[9] The IRS has regulatory authority under the Act to provide guidance to apply the reporting requirements described in this section to a United States entity that is formed or used for purposes of holding the foreign assets described in this section.

[10] There are at least five separate reporting regimes for foreign financial assets. See sections 6038, 6038B, 6038D, 6046A, and 6048.

D. Extend Statute of Limitations for Significant Omissions of Income Attributable to Foreign Financial Assets

Under the Act, if a taxpayer omits from gross income more than $5,000 attributable to a foreign financial account that is required to be disclosed to the IRS (under the Act, but without applying the $50,000 aggregate account value threshold, or any other reporting regime that exists under current law for foreign financial assets),[11] the statute of limitations with respect to that item will be six years (as opposed to three years) after the required return was filed. This provision is effective for tax returns filed after the date of enactment, and for returns whose statute of limitations have not expired as of the date of enactment.

E. Reporting of Activities With Respect to PFICs

Under pre-Act law, a U.S. shareholder in a passive foreign investment company (a "PFIC") is required to file an information return with the IRS if the shareholder recognizes gain on the sale of PFIC stock, receives a distribution from a PFIC, or made a reportable election.[12] Under the Act, each U.S. shareholder in a PFIC must also file an annual report containing any information required by the IRS.[13] This provision is effective immediately and therefore appears to apply to 2009 tax returns not yet filed, although the provision does not indicate the information that the shareholders are required to report.

IV. Withholding on Dividend Equivalent Payments Under Equity Swaps

A. In General

U.S.-source dividend payments made to a foreign person are generally subject to a 30% withholding tax. Similarly, substitute dividend payments made to a foreign person on securities loans, sale-repurchase agreements, and substantially similar agreements with respect to U.S. equity securities are subject to a 30% withholding tax.[14] However, under pre-Act law, substitute dividend

---

[11] This includes the reporting regimes that exist under current law in sections 6038, 6038B, 6046A, and 6048.

[12] Thus, a shareholder that has elected to mark-to-market its actively-traded PFIC stock under section 1296 and report any increase in the stock's value during the year as ordinary income, would be required to file a report annually with respect to the PFIC.

[13] A U.S. shareholder in a PFIC may also be required to disclose information with respect to its foreign financial assets under other provisions of the HIRE Act, but it is anticipated that Treasury will issue regulations to avoid duplicative reporting. See Staff of the Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act," Under Consideration by the Senate, JCX-4-10, p. 67 (February 23, 2010) (the "JCT Report").

[14] Treasury regulations section 1.861-3(a)(6) (substitute dividend payments on security loans and sale-repurchase agreements are sourced in the same manner as the underlying dividend).

payments made under to a foreign person under an equity swap are not generally subject to any U.S. withholding tax.[15]

Beginning September 14, 2010, any payment to a foreign counterparty on an equity swap (or any other substantially similar payment on some other financial instrument) that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a U.S.-source dividend will be subject to a 30% U.S. withholding tax if:

- the foreign counterparty transferred the underlying stock to its counterparty in connection with the transaction (i.e., the underlying stock "crossed in"),
- the counterparty transfers the underlying stock to the foreign counterparty at the termination of the transaction (i.e., the underlying stock "crosses out"),
- the underlying stock is not readily tradable on an established securities market,[16]
- the underlying stock is posted as collateral to the foreign party, or
- the equity swap is otherwise identified by Treasury as subject to withholding.

Moreover, beginning September 14, 2010, a 30% U.S. withholding tax will be imposed on any substitute dividend payment made to a foreign party pursuant to a securities lending or sale-repurchase transaction, or any substantially similar payment on some other financial instrument, that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a U.S.-source dividend.

After March 18, 2012, a 30% U.S. withholding tax will be imposed on any payment on any notional principal contract that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a U.S.-source dividend, or any substantially similar payment on another financial instrument, except to the extent that regulations are issued that provide that the notional principal contract (or other instrument) does not have the potential for tax avoidance.

Neither the Act nor the Technical Explanation prepared by the Staff of the Joint Committee on Taxation indicate the characteristics of a notional principal contract that does not have the potential for tax abuse. However, prior versions of the Act suggest that the following factors will be relevant:

---

[15] See Treasury regulations section 1.863-7(b) (the source of notional principal contract income is determined by reference to the residence of the recipient).

[16] For this purpose, an index or fixed basket of securities will be treated as a single security. The JCT Report provides that such a security will be treated as regularly traded on an established securities market only if every component of the index or fixed basket is a security that is regularly tradable on an established securities market. See JCT Report, p. 79.

- **The term of the swap.** If the term of the swap begins shortly before and ends shortly after a dividend date, it suggests that the notional principal contract is being used to avoid dividend withholding. The Obama Administration's Tax Proposals for Fiscal Year 2010 suggest that a swap with a term of at least 90 days would not be abusive.

- **The amount of each party's investment in the contract and the amount of collateral posted.** If the foreign counterparty makes a substantial upfront payment on the contract, or is required to post as collateral an amount equal to a significant portion of the notional, the contract is economically similar to an investment in the underlying stock. The Obama Administration's Tax Proposals for Fiscal Year 2010 suggested that collateral equal to 20% of the notional amount of the contract would not be abusive. However, it is anticipated that any regulations would allow more than 20% (and possibly as much as 50%) of the notional amount of a contract to be posted as collateral.

- **Whether the price of the equity used to measure the parties' entitlements or obligations is based on an objectively observable price.** If the price of the underlying stock used to measure the parties' entitlements and obligations under the contract is based on an objectively observable price, the contract is less likely to be viewed as abusive. The Obama Administration's Tax Proposals for Fiscal Year 2010 suggested that the prices of the underlying stock used to measure the parties' entitlements or obligations should be based on objectively observable prices. It is anticipated that any regulations would permit some use of "variable weighted average price" ("VWAP") and time weighted average price ("TWAP"). The use of "market on open" and "market on close" prices is more controversial.

- **Whether there is crossing-in or crossing-out.** If the foreign counterparty transfers the underlying stock to its counterparty at the inception of the transaction (i.e., the stock "crosses in") or receives the stock from its counterparty at the termination of the transaction (i.e., the stock "crosses out"), the transaction is likely to be viewed as abusive.

- **References to the hedge position of either party.** A reference in the contract to the hedge of one of the parties, or a term that would require the counterparty to own the underlying stock, has been noted as an abusive factor. The Obama Administration's Tax Proposals for Fiscal Year 2010 suggested that the terms of the contract should not address the hedge position of the counterparty.

- **Liquidity of the underlying stock.** If the underlying stock is illiquid or nonfungible, the transaction is likely to be viewed as abusive. The Obama Administration's Tax Proposals for Fiscal Year 2010 suggested that the liquidity and fungibility criteria

would be satisfied if the underlying stock is publicly traded and the notional amount of the swap represents less than 5% of the total public float of that class of stock and less than 20% of the 30-day average daily trading volume.

B. Effect of the Act on Outstanding Equity Swaps

If a foreign person has entered into an equity swap under a standard (unmodified) ISDA Master Agreement prior to March 18, 2010, and is subject to withholding under the Act on a dividend equivalent payment made on or after September 14 (because, for example, the foreign party transferred stock to its counterparty in connection with the transaction), the foreign counterparty will be entitled to a "gross-up" payment that results in the foreign counterparty receiving the same payment it would have received had no amount been withheld.[17] Under the terms of the ISDA Master Agreement (unless otherwise modified), a party that will be obligated to pay a gross up amount on the next scheduled payment date under the swap (referred to as the "Affected Party") may take the following steps to terminate the swap.[18]

First, the Affected Party must promptly notify the foreign counterparty of the impending gross-up obligation.[19] Second, the Affected Party must make reasonable efforts to transfer the swap within twenty days.[20] If the Affected Party is unable to mitigate its gross-up obligation through a transfer within the 20-day period,[21] it must notify the foreign counterparty within the 20-day period, and the foreign counterparty then has the option within 30 days to transfer the swap to an affiliate that would not be subject to withholding (e.g., to a U.S. affiliate).[22] If the foreign counterparty does not transfer the swap to an affiliate that is not subject to withholding within the 30-day period, the Affected Party may designate a termination date for the swap upon not more than 20-day notice.[23]

For equity swaps entered into after March 18, 2010, which remain outstanding on September 14, 2010, and (i) involve a cross-in or cross-out, (ii) with respect to which the underlying stock is not readily tradeable on an established securities market, (iii) the underlying stock is posted as

---

[17] Section 2(d)(i)(4) of the ISDA Master Agreement.

[18] Section 5(b)(ii) and section 6(b)(iv) of the ISDA Master Agreement generally provide a party the right to terminate a swap if, as the result of a change in law (which generally includes the enactment or change of any law or a change in the application or official interpretation of any law) after the date on which the swap was entered into, there is a substantial likelihood that the party will be required to pay to the other party a gross-up payment in respect of taxes on the next scheduled payment date.

[19] Section 6(b)(i) of the ISDA Master Agreement.

[20] Section 6(b)(ii) of the ISDA Master Agreement.

[21] We do not believe that a transfer will successfully mitigate withholding imposed under the Act.

[22] Section 6(b)(ii) of the ISDA Master Agreement.

[23] Section 6(b)(iv) of the ISDA Master Agreement.

collateral to the foreign party, or (iv) are identified as being subject to withholding prior to the date they were entered into, the foreign party will be entitled to a gross-up, but the counterparty will not have the right to terminate the swap.

The treatment of all other equity swaps entered into after March 18, 2010 will depend upon future Treasury regulations or other guidance. We recommend that all parties to cross-border equity swaps relating to U.S. equity securities entered into after March 18, 2010 carefully consider the appropriate burden of possible U.S. withholding tax.

* * * *

If you have any questions regarding this memorandum, please contact any member of the Cadwalader Tax Department.