Negotiating ISDA Master Agreement Schedules on Behalf of Foreign Hedge Funds

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International financial dealings, complicated to begin with, have become even more complicated as a result of recent U.S. legislation imposing new reporting and withholding requirements. Practitioners need to be familiar with existing rules, and draft agreements with care, while awaiting additional guidance and the clarification of certain ambiguities.

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Practitioners (and their clients) often expect that negotiating the tax-related provisions of a swap [1] documented on an ISDA Master Agreement will be straightforward. After all, Treasury Regulations provide several safe harbors and there are certain standard representations. Consideration of the complexities and ambiguities involved, however, may lead an ISDA negotiator to approach an ISDA Master Agreement Schedule with a more cautious mindset.

Both substantive and technical issues arise in crafting ISDA Master Agreement Schedule provisions. Negotiating an ISDA Master Agreement Schedule on behalf of a foreign hedge fund is particularly complex. Negotiators need to consider carefully the representations, tax forms, and other modifications that they both request and provide.

BACKGROUND

Nearly all over-the-counter derivative transactions are documented under a standardized, pre-printed Master Agreement (the "ISDA Master Agreement") published by the International Swaps and Derivatives Association, Inc. (ISDA). While many parties continue to use the 1992 version of the ISDA Master Agreement, others are increasingly using the updated 2002 version. [2]

The ISDA Master Agreement (of either version) governs the overall over-the-counter derivative trading relationship between the parties, and contains the non-transaction-specific credit and operational terms that apply to all transactions entered into by the parties under the ISDA Master Agreement. Typically, modifications to the standardized terms are not made to the ISDA Master Agreement itself. Instead, the parties negotiate

amendments to the ISDA Master Agreement, make certain required elections, and provide certain information in a schedule to the ISDA Master Agreement (the "Schedule"). The Schedule also contains the specific tax representations made by the parties and the agreements to deliver tax forms.

The specific terms of each transaction (e.g., the trade and termination dates, the underlying security, notional amount, and financing rate) are specified in a confirmation under the ISDA Master Agreement. In addition, parties may agree to secure obligations under the ISDA Master Agreement, typically by transferring liquid collateral based on mark-to-market exposures on a daily basis, pursuant to a Credit Support Annex published by ISDA.

Aside from the tax representations and tax forms, the ISDA Master Agreement provides important tax-related provisions. First, it allocates withholding tax risk among the parties. In general, the payer bears the economic burden of any withholding tax that is imposed on a payment under the swap. Generally, if a payment is subject to an "indemnifiable tax," [3] the payer is required to gross up the payment to the payee so that the payee receives what it would have received under the terms of the swap absent the tax. [4]

In addition, the ISDA Master Agreement provides that if a withholding tax is imposed as a result of the occurrence of certain events, the party that bears the economic burden of the withholding tax may terminate the swap early. [5] For example, if as a result of an action by a tax authority or a "change in tax law" [6] a party will, or there is a substantial likelihood that a party will, be required to make a gross-up payment or to receive a payment from which an amount is withheld and a gross-up is not required, then the affected party may terminate the agreement.

Tax practitioners negotiating ISDA Master Agreement Schedules need to address three tax issues:

(1) Withholding tax.
(2) Form 1042-S reporting.
(3) Form 1099 information reporting and backup withholding.

Withholding Tax

Subject to the discussion below regarding the recently enacted Hiring Incentives to Restore Employment Act (the "HIRE Act"), swap payments are not subject to U.S. withholding tax. [7] Generally, a payment made to a non-U.S. person is subject to U.S. withholding tax if the payment has a U.S. source and if it constitutes fixed or determinable annual or periodical (FDAP) gains, profits, or income. [8]

Although Treasury and the IRS consider a non-U.S. person's income from swaps to be FDAP, [9] such income is not U.S. source. Treasury Regulations provide that swap income is sourced by reference to the residence of the recipient of such income as determined under a variant of the rules applicable to foreign currency transactions. [10] Those rules provide that in the case of an individual, such individual's residence is his or her tax home, and in the case of an entity that is not a U.S. person, such entity's residence is a country other than the U.S. [11] Therefore, swap income earned by a non-U.S. person is not U.S. source, and is not subject to U.S. withholding tax. [12]

Certain payments made in respect of a swap may be characterized as interest. For example, if a swap is structured to provide for a "significant nonperiodic payment,"

including a "significant" upfront payment, it is bifurcated into two transactions—an on-market swap and a loan. [13] Payments on the swap attributable to the time value component associated with the loan are treated as interest for all purposes of the Code. [14]

If a foreign hedge fund makes a "significant nonperiodic payment" to a U.S. broker-dealer, a portion of the subsequent payments by the U.S. broker-dealer to the foreign hedge fund will be considered U.S. source interest [15] and therefore will be subject to 30% withholding tax unless an exception applies. [16] Under the "portfolio interest exception," the interest will not be subject to withholding if, generally and among other requirements, the swap is in registered form and the foreign hedge fund owns less than 10% of the total combined voting power of the U.S. broker-dealer, is not a controlled foreign corporation (CFC) related to the U.S. broker-dealer, is not a bank receiving the interest on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business, and delivers a Form W-8 to the U.S. broker-dealer. [17] Typically, the foreign hedge fund will be organized in a tax haven jurisdiction and will therefore not qualify for treaty benefits in respect of any interest paid or "deemed paid" under the swap. [18]

Form 1042-S Reporting

Reg. 1.1461-1(c)(2) requires that certain amounts paid to a foreign payee—including amounts subject to withholding (even if no amount is withheld due to a treaty or other exception) and amounts that are or are presumed to be effectively connected income (ECI)—be reported to the IRS on Form 1042-S. Reg. 1.1441-4(a)(3)(i) provides that in certain cases, a withholding agent must treat swap income (but not associated interest income) as ECI, and therefore must file a return on Form 1042-S in respect of such swap income. [19] If, however, a payee provides a representation in an ISDA Master Agreement Schedule that the payee is a "U.S. person" or is a "non-U.S. branch of a foreign person," [20] the payment will not be treated as ECI, [21] and therefore will not have to be reported to the IRS on Form 1042-S. [22]

As described above, certain payments made in respect of a swap may be characterized as interest. Such interest payments to a foreign payee also must be reported on Form 1042-S (even if the "portfolio interest exception" applies so that there is no withholding tax on such interest). [23]

Form 1099 Information Reporting/Backup Withholding

Section 6041(a) requires information returns to be filed with IRS on Form 1099 in respect of certain payments of $600 or more. Regulations under Section 6041 provide that, in general, swap payments to non-exempt recipients are required to be reported on Form 1099, while swap payments to certain exempt recipients, defined by cross-reference to the Regulations under Section 6049, are not reportable. [24]

Exempt recipients include corporations, financial institutions (including banks), and swap dealers. [25] Section 6041(h), however, enacted as part of the Patient Protection and Affordable Care Act (P.L. 111-148, 3/23/10) (PPACA) and discussed in more detail below, provides that notwithstanding any Regulations promulgated prior to its enactment, information reporting under Section 6041 is required in respect of payments to corporations (other than tax-exempt corporations) after 2011.

Swap payments treated as interest (e.g., as a result of a "significant nonperiodic payment") are reportable as swap payments, and not as interest payments under Section

6049. [26] Pursuant to a regulatory safe harbor, information reporting on Form 1099 is not required in respect of a swap payment if (1) the payment is treated as ECI under the Section 1441 Regulations, or (2) the payee provides a representation in an ISDA Master Agreement Schedule that it is a "foreign person." [27] In addition, information reporting on Form 1099 is not required if the payee provides a Form W-8 certifying that the payee is a foreign person. [28]

Section 3406(a) requires payers to backup withhold, currently at a rate of 28%, in respect of certain "reportable payments" if the payee fails to certify its taxpayer identification number or if certain other conditions are met. Payments required to be reported under Section 6041 on Form 1099 are generally reportable payments. [29] As noted above, swap payments treated as ECI, in respect of which a "foreign person" representation is provided, and in respect of which a Form W-8 is provided, are not required to be reported under Section 6041 on Form 1099, and therefore are not reportable payments subject to backup withholding. Payments to exempt recipients also are not reportable payments and are therefore not subject to backup withholding. In addition, a payment to a U.S. person that provides a taxpayer identification number is not subject to backup withholding. [30]

While taxpayer identification numbers often are provided on a Form W-9 (which is the form prescribed under Section 3406 on which certain certifications are made under penalties of perjury), [31] a payee in respect of payments that are subject to reporting under Section 6041 (such as swap payments) is not required to certify under penalties of perjury (and therefore not required to deliver a Form W-9 certification) that the taxpayer identification number is correct. [32]

HIRE Act

The HIRE Act contains two sets of provisions that are relevant to foreign hedge funds entering into swap agreements.

New Section 871(m)(1) [33] provides that, effective with respect to payments made after 9/13/10, a "dividend equivalent" is treated as a U.S. source dividend. A "dividend equivalent" includes a payment on a "specified notional principal contract" that "(directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States." [34] A "specified notional principal contract" includes a notional principal contract that is identified by Treasury as a specified notional principal contract, or a notional principal contract pursuant to which:

> (1) The long party transfers the underlying security to the short party in connection with entering into such contract (cross in);
> (2) The short party transfers the underlying security to the long party in connection with the termination of such contract (cross out);
> (3) The underlying security is not readily tradable on an established securities market [35]; or
> (4) The underlying security is posted as collateral by the short party with the long party in connection with entering into such contract. [36]

In addition, for payments made after 3/17/12, *any* notional principal contract is a specified notional principal contract unless Treasury determines that such contract does not have the potential for tax avoidance. [37] Therefore, dividend-related payments to foreign parties in connection with certain equity swaps with U.S. underlyings (and, after 3/17/12, in connection with all equity swaps with U.S. underlyings not specifically

exempted), will be considered U.S. source payments subject to 30% U.S. withholding tax.

In addition, Section 1471(a) provides that, in respect of payments made after 2012,[38] a withholding agent must withhold 30% from any "withholdable payment" to a "foreign financial institution" that does not comply with the requirements set forth in Section 1471(b). Foreign hedge funds and foreign swap dealers will be considered "foreign financial institutions."[39] A "withholdable payment" includes, among other items, U.S. source interest, dividends, and FDAP income, and gross proceeds from the sale or other disposition of property of a type that can produce U.S. source interest or dividends, but does not include ECI.[40]

As noted above, certain swap payments may constitute U.S. source interest, and certain swap payments may, pursuant to Section 871(m), constitute U.S. source dividends. Therefore, unless a foreign counterparty complies with the requirements of Section 1471(b), such U.S. source interest and U.S. source dividend payments made after 2012 will be subject to 30% withholding tax.[41] Section 1471(b) generally requires a foreign financial institution to enter into an agreement with Treasury pursuant to which it agrees to obtain certain information regarding its account holders, to report certain information regarding holders of "United States accounts" and, unless a specified election is made, to withhold a 30% tax in respect of payments to certain account holders.

ISDA PROVISIONS—PAYEE REPRESENTATIONS AND TAX FORMS

Each party to an ISDA Master Agreement typically provides "payee representations" to the other party in section 2 of a Schedule to the ISDA Master Agreement.[42] In addition, section 3 of the Schedule generally provides that each party will deliver certain tax forms to the other party. Because, as noted above (and subject to the discussion of the HIRE Act), swap payments are not subject to U.S. withholding tax, the payee representations and tax forms typically are not relevant to minimizing U.S. withholding tax on swap payments. Nevertheless, the payee representations and tax forms are important (1) to reduce or prevent withholding tax on payments treated as interest and (2) to prevent reporting on Form 1042-S, reporting on Form 1099, and backup withholding.

The payee representations and tax forms provided by a party will depend on the party's jurisdiction and the nature of the party (i.e., whether it is a corporation or a partnership), among other factors. The discussion below considers the relevant representations and tax forms in the following three scenarios:

> (1) A swap between a U.S. broker-dealer and a Cayman Islands hedge fund treated as a corporation for U.S. federal income tax purposes (e.g., a stand-alone foreign fund in a parallel fund structure) (a "Foreign Hedge Fund Corporation").
> (2) A swap between a U.S. broker-dealer and a Cayman Islands hedge fund treated as a partnership for U.S. federal income tax purposes (e.g., a foreign master fund in a "master/feeder" fund structure) (a "Foreign Hedge Fund Partnership").
> (3) A swap between a foreign broker-dealer and a Cayman Islands hedge fund (treated as a corporation or as a partnership for U.S. federal income tax purposes) (a "Foreign Fund"). This third scenario may be further broken down between a foreign broker-dealer with respect to which income on the swap is ECI, and a foreign broker-dealer with respect to which income on the swap is not ECI.

U.S. Broker-Dealer/Foreign Hedge Fund Corporation

Each party will want to make certain representations, and will want the other party to make certain representations.

U. S. broker-dealer. The Foreign Hedge Fund Corporation should ask the U.S. broker-dealer to represent that "it is a 'U.S. person' (as that term is used in section 1.1441-4(a)(3)(ii) of United States Treasury Regulations) for United States federal income tax purposes." This representation is one of the sample representations provided in the Schedule to the 2002 ISDA Master Agreement.

If the representation is provided, the U.S. broker-dealer will have satisfied the safe harbor described above, and the Foreign Hedge Fund Corporation will not be required to report to the IRS on Form 1042-S swap payments made to the U.S. broker-dealer. A U.S. broker-dealer often will represent that it is "organized under the laws of state × and its taxpayer identification number is y." This form of representation also should be sufficient to prevent Form 1042-S reporting (as it is essentially a representation as to the status of the broker-dealer as a U.S. person).

To be certain that it is not required to report or backup withhold from payments made to the U.S. broker-dealer, the Foreign Hedge Fund Corporation should ask the U.S. broker-dealer to deliver a complete and accurate Form W-9, or at least to provide its taxpayer identification number in a representation. Even if a Form W-9 or a taxpayer identification number were not provided by the U.S. broker-dealer, the Foreign Hedge Fund Corporation likely would not be required to report on Form 1099 or backup withhold in respect of payments to the U.S. broker-dealer (although with the enactment of PPACA in March 2010, this result is less clear in respect of payments made after 2011).

As described above, Reg. 1.6041-1(d)(5) provides that information is not required to be reported in respect of payments to certain exempt recipients described in Reg. 1.6049-4(c)(1)(ii). Such exempt recipients include financial institutions such as banks, and a payer may treat a person as an exempt recipient without requiring a certificate if the person's name reasonably indicates the payee is a financial institution described in the Regulation. [43] A swap dealer also is an exempt recipient under such Regulations. [44]

As part of PPACA, however, Section 6041(h) was added to the Code in March 2010. [45] It provides that, after it becomes effective on 1/1/12, "[n]otwithstanding any regulation prescribed by the Secretary before the date of the enactment of this subsection, for purposes of this section the term 'person' includes any corporation that is not an organization exempt from tax under section 501(a)." As a result, information reports otherwise required under Section 6041 must be made in respect of payments to corporations (other than tax-exempt organizations).

Read literally, Section 6041(h) would override all existing Regulations under Section 6041, and would require information reporting in respect of payments to corporate payees that were otherwise exempt recipients for reasons unrelated to their corporate status, such as financial institutions or swap dealers receiving swap payments. This literal reading would require the Foreign Hedge Fund Corporation to report on Form 1099 swap payments to the U.S. broker-dealer, and would require backup withholding in respect of such payments if a Form W-9 or a taxpayer identification number were not provided. [46]

A better reading of Section 6041(h), however, is that it overrides only those Regulations providing that a payee is an exempt recipient due to its status as a corporation, but that other exemptions remain in place even if the payee happens to be a corporation. This

reading is supported by the Treasury's General Explanations of the budget proposal that included the change to Section 6041. The General Explanations, in describing the reasons for change, states that "during the decades in which the regulatory exception for payments to corporations has become established, the number and complexity of corporate taxpayers have increased," [47] indicating that the proposal was intended to repeal the exception for corporations but not necessarily the other regulatory exceptions (even if they happen to apply to certain corporations). [48]

If this interpretation of Section 6041(h) is correct, payments made after 2011 to the U.S. broker-dealer would not be subject to information reporting (or backup withholding), even without the provision of a Form W-9 or a taxpayer identification number. One might hope that Regulations (authorized by Section 6041(i)) will clarify the scope of Section 6041(h). [49]

Foreign Hedge Fund Corporation. The Foreign Hedge Fund Corporation will want to make a number of payee representations.

Assuming that the Foreign Hedge Fund Corporation takes the position that its income from the swaps is not ECI, [50] it will want to make a representation that the U.S. broker-dealer can rely on in concluding that it is not required to report swap payments to the fund on Form 1042-S. As described above, to rebut the ECI presumption and to prevent Form 1042-S reporting, a foreign counterparty typically will represent that it is a "non-U.S. branch of a foreign person (as that term is used in section 1.1441-4(a)(3)(ii) of United States Treasury Regulations) for United States federal income tax purposes."

While some Foreign Hedge Fund Corporations make this representation, others question whether it is appropriate. If the investment team for the Foreign Hedge Fund Corporation sits and trades in the fund's New York office, is it correct that the fund is receiving the swap payments as a non-U.S. branch of a foreign person? When the Section 1441 Regulations and the "non-U.S. branch of a foreign person" safe harbor were first finalized in 1997, before being amended in 2000, the applicable Treasury Decision stated that the counterparty could represent that it is "a non-U.S. *office* of a foreign person." [51]

Many hedge funds and practitioners interpret the non-U.S. branch of a foreign person representation as essentially a representation that the income is not ECI, which is a representation they feel comfortable making. Others, however, hesitate in making the representation. If the representation is not made, how can a Foreign Hedge Fund Corporation ensure that the U.S. broker-dealer will not report swap payments on Form 1042-S?

As an alternative, some Foreign Hedge Fund Corporations simply represent that their income from the swap transactions is not effectively connected with the conduct of a trade or business in the U.S. [52] They take the position that although such a representation does not qualify for the safe harbor in the Regulations, it goes to the heart of the issue raised by the Regulations and should be sufficient to rebut the ECI presumption and to prevent Form 1042-S reporting. This author believes that this representation, in conjunction, crucially, with the delivery of a Form W-8, is sufficient.

In fact, the Form W-8 alone, even without the representation, should suffice. Many IRS publications indicate that this is the case, [53] and several commentators also have so concluded. [54] In addition, this position can be inferred from some Regulations. First, the prior final Regulations permitted delivery of a Form W-8 to rebut the ECI presumption, [55] and limited the representation safe harbor to financial institutions. When the Regulations were revised, the Preamble to TD 8881, 5/16/00, stated that the prior ECI presumption

rule was "overly broad" and that the amendments to the prior final Regulations were intended to "limit the presumption that notional principal contract income is effectively connected to a U.S. trade or business...." It would not be consistent with Treasury's goal of limiting the ECI presumption if providing a Form W-8 were not sufficient to rebut the ECI presumption.

In addition, Reg. 1.1441-4(a)(3)(ii) as currently in effect, in describing the representation safe harbor, retains the language that states "even if no withholding certificate is furnished." This implies that if a withholding certificate is provided, the representation is not necessary and that the representation is a safe harbor if the certificate is not provided.

A Foreign Hedge Fund Corporation that provides a Form W-8BEN, then, has a strong position that swap payments made to it should not be reported on Form 1042-S, notwithstanding that it does not provide a "non-U.S. branch of a foreign person" representation. It may be helpful, though, also to provide a representation stating that income from the swap is not ECI.

To prevent information reporting on Form 1099 (and potential backup withholding), the Foreign Hedge Fund Corporation that has not already represented that it is a non-U.S. branch of a foreign person (possibly for the reasons noted above) should make the "foreign person" representation described by the Section 6041 Regulations. Technically, a Foreign Hedge Fund Corporation that already has represented that it is a "non-U.S. branch of a foreign person" would not also have to represent that it is a "foreign person," [56] but the "foreign person" representation is commonly made even in this situation. [57]

As described above, if a Foreign Hedge Fund Corporation makes a "significant" nonperiodic payment on a swap, certain payments by the U.S. broker-dealer to the Foreign Hedge Fund Corporation will be characterized as U.S. source interest subject to withholding tax. [58] Counterparties often represent that they qualify for treaty benefits in respect of the interest component of swap payments, but a Foreign Hedge Fund Corporation organized in the Cayman Islands will not qualify for treaty benefits as there is no U.S.-Cayman Islands income tax treaty. Therefore, the Foreign Hedge Fund Corporation will need to rely on the portfolio interest exemption to avoid withholding tax on interest. [59]

Although not required or authorized as a safe harbor by the Regulations, [60] a Foreign Hedge Fund Corporation generally will be asked to represent that it satisfies the various prongs of the portfolio interest exemption. [61] For example, it would be asked to represent that it is not a bank that has entered into the agreement in the ordinary course of its trade or business of making loans, that it is not a 10% shareholder of the U.S. broker-dealer within the meaning of Section 871(h)(3)(B), and that it is not a CFC related to the U.S. broker-dealer within the meaning of Section 881(c)(3)(C). [62] The Foreign Hedge Fund Corporation also would be asked to provide a Form W-8BEN. [63]

While the Foreign Hedge Fund Corporation should provide a Form W-8BEN [64] (and may be providing it for other reasons, as discussed above), the Foreign Hedge Fund Corporation might resist making the portfolio interest representation on the grounds that a representation is not required to qualify for the portfolio interest exemption, and thus it should not be required to assume liability for a representation that is not necessary. [65]

If the U.S. broker-dealer were to then conclude that it was not comfortable that the Foreign Hedge Fund Corporation qualified for the portfolio interest exemption and therefore that it must withhold on interest payments, the withholding tax would be an

"indemnifiable tax" under the ISDA Master Agreement. The U.S. broker-dealer then would be required to gross up the Foreign Hedge Fund Corporation for the withholding tax under the terms of the ISDA Master Agreement. [66] The Foreign Hedge Fund Corporation should provide the representation, however, if the U.S. broker-dealer requires the representation in order to get comfortable that there is no withholding/gross-up risk, and would change the pricing for the swap or would be unable to enter into the swap if the representation were not provided. [67]

The portfolio interest exemption generally applies only if the relevant obligation is in registered form. [68] One way for an obligation to be considered in registered form is if "[t]he right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system maintained by the issuer (or its agent)." [69] An obligation is "considered transferable through a book entry system if the ownership of an interest in the obligation is required to be reflected in a book entry" and "[a] book entry is a record of ownership that identifies the owner of an interest in the obligation." [70]

While many practitioners take the position that a swap documented on an ISDA Master Agreement is considered to be in registered form, [71] this conclusion is not free from doubt. [72] A U.S. broker-dealer, then, may propose to amend the ISDA Master Agreement by providing in the Schedule that transfers of rights and obligations under the agreement will not be recognized unless the transferee party provides the other party to the agreement with the name and address of the transferee. [73] It would be reasonable for the Foreign Hedge Fund Corporation to accept this modification.

Notwithstanding that withholding may not be required in respect of the interest component of a swap payment, such interest payments to the foreign hedge fund will have to be reported on Form 1042-S. [74] This will be true regardless of any representations made by, or tax forms delivered by, the Foreign Hedge Fund Corporation.

U.S. Broker-Dealer/Foreign Hedge Fund Partnership

Once again, each party will want to make certain representations, and will want the other party to make certain representations.

U. S. broker-dealer. The discussion above regarding the U.S. broker-dealer's deliverables with respect to a transaction with a Foreign Hedge Fund Corporation applies equally to a transaction with a Foreign Hedge Fund Partnership.

Foreign Hedge Fund Partnership. The Foreign Hedge Fund Partnership will want to make representations and/or deliver tax forms to prevent reporting on Form 1042-S of swap payments made to it, but drafting the appropriate representations for the partnership is not straightforward. [75] As noted in the Foreign Hedge Fund Corporation discussion above, a foreign hedge fund may be comfortable making a representation that it is a "non-U.S. branch of a foreign person." Even in that case, though, it will run into a potential technical issue if it is a partnership for U.S. federal income tax purposes. Reg. 1.1441-4(a)(3)(ii) provides that the ECI presumption will be rebutted if "the *payee* provides a representation ... that the *payee* is a U.S. person or a non-U.S. branch of a foreign person" (emphasis added). [76]

Most Foreign Hedge Fund Partnerships are "nonwithholding foreign partnerships," and the payees with respect to a nonwithholding foreign partnership are generally the partners of such partnership, not the partnership. [77] Technically, then, a representation that the Foreign Hedge Fund Partnership is a "non-U.S. branch of a foreign person" should not

qualify for the regulatory safe harbor. To so qualify, the representation must address the status of, and must come from, the partners of the Foreign Hedge Fund Partnership.

In a typical "master/feeder" hedge fund structure, the foreign master fund treated as a partnership for U.S. federal income tax purposes has three partners—the general partner (often a U.S. entity), the onshore feeder fund (often a U.S. partnership for U.S. federal income tax purposes), and the offshore feeder fund (often a foreign corporation for U.S. federal income tax purposes). These partners are not parties to the ISDA Master Agreement and therefore cannot provide representations.

To comply as closely as possible with the literal language of the regulatory safe harbor, the Foreign Hedge Fund Partnership might represent on behalf of each partner as agent for each partner (typically the feeder funds and the general partner in the "master/feeder" fund context) that each such partner is either a "U.S. person" or a "non-U.S. branch of a foreign person." To cover all bases, the Foreign Hedge Fund Partnership also might represent that it is a "non-U.S. branch of a foreign person."

In addition to the technical issue just described, some foreign hedge funds are not comfortable making the "non-U.S. branch of a foreign person" representation, as described in the Foreign Hedge Fund Corporation discussion above. A Foreign Hedge Fund Partnership that does not want to address the substantive or the technical issues surrounding the "non-U.S. branch of a foreign person" representation may provide a Form W-8IMY, with the appropriate attached tax forms and allocation statement, to rebut the ECI presumption. As described in the Foreign Hedge Fund Corporation discussion above, a swap counterparty that provides a Form W-8 (other than a Form W-8ECI) has a strong position that swap payments it receives are not subject to reporting on Form 1042-S. It also is helpful for the Foreign Hedge Fund Partnership to represent that payments made to it under the swap are not ECI.

With respect to preventing information reporting on Form 1099, the Foreign Hedge Fund Partnership may wish to represent that it is a "foreign person." Here again, though, a foreign partnership will confront a technical issue. Should the Foreign Hedge Fund Partnership represent that it is a "foreign person" or, because it is a nonwithholding foreign partnership, should it make the representation on behalf of and as agent for its partners? [78]

Whether the Foreign Hedge Fund Partnership or its partners is the subject of the representation would likely lead to a practical difference with respect to the information reported, if any, by the U.S. broker-dealer. If the Foreign Hedge Fund Partnership represents that it is a "foreign person," the U.S. broker-dealer is likely to rely on that representation in not reporting *any* of the swap payments on Form 1099. If the Foreign Hedge Fund Partnership represents that each of its partners is either a "U.S. person" or a "foreign person" (and the percentages owned by each), the U.S. broker-dealer may (and should) report payments to the Foreign Hedge Fund Partnership attributable to the U.S. partners' interests on Form 1099. Because the Foreign Hedge Fund Partnership is a nonwithholding foreign partnership, it would appear appropriate to look through to its partners and make the representation concerning the status of its partners. [79]

A Foreign Hedge Fund Partnership that makes the representation only about its own foreign status, though, does have a technical argument for satisfying the regulatory safe harbor with such a representation. Reg. 1.6041-4(a)(4) provides that reporting of swap payments on Form 1099 is not required "if the *payee* provides a representation ... that the *counterparty* is a foreign person" (emphasis added). Read literally, the regulatory safe harbor provides that the subject of the representation is the counterparty to the

swap, which in this case is the Foreign Hedge Fund Partnership. Therefore, even if the Foreign Hedge Fund Partnership makes the representation on behalf of and with respect to its partners, to cover all bases, it also might make the "foreign person" representation on its own behalf.

As with the Foreign Hedge Fund Corporation, a U.S. broker-dealer may ask a Foreign Hedge Fund Partnership to represent that it qualifies for the portfolio interest exemption. The discussion above regarding whether a Foreign Hedge Fund Corporation should agree to provide such a representation applies equally to a transaction with a Foreign Hedge Fund Partnership. If the Foreign Hedge Fund Partnership agrees to make a portfolio interest representation, it must consider the subject of the representation. Reg. 1.871-14(g)(3)(i) provides that with respect to a partnership, the 10% test for purposes of the portfolio interest exception is conducted at the partner level. The representation in respect of this prong of the portfolio interest exemption should therefore be made at the partner level, and the representations in respect of the other prongs of the portfolio interest exception presumably should be made at the partner level as well.

Therefore, if the Foreign Hedge Fund Partnership agrees to make a portfolio interest representation, it should represent that none of its foreign partners (1) is a bank that has entered into the agreement in the ordinary course of its trade or business of making loans, (2) is a 10% shareholder of the U.S. broker-dealer within the meaning of Section 871(h)(3)(B), or (3) is a CFC related to the U.S. broker-dealer within the meaning of Section 881(c)(3)(C). The Foreign Hedge Fund Partnership also may be asked to provide, and should agree to provide, a Form W-8IMY with the applicable attachments (which it may be providing for other reasons, as described above). In addition, it would be reasonable for the Foreign Hedge Fund Partnership to agree to add the transfer provision described above to strengthen the position that the swap is in registered form for purposes of the portfolio interest exemption.

As with the Foreign Hedge Fund Corporation, reporting of interest payments to the Foreign Hedge Fund Partnership on Form 1042-S will be required in respect of the interest attributable to the Foreign Hedge Fund Partnership's foreign partners. [80] Again, this will be the case regardless of any representations made by, or tax forms delivered by, the Foreign Hedge Fund Partnership.

Foreign Broker-Dealer/Foreign Fund

Different considerations apply when the transaction is between foreign parties.

Foreign broker-dealer. It appears to be common practice among foreign broker-dealers to neither require nor provide any payee tax representations or tax forms in "foreign to foreign" transactions with respect to which payments are made outside the U.S. [81] Nevertheless, Schedules documenting swaps on U.S. equities that are affected by the provisions of the HIRE Act, and possibly Schedules documenting all swaps, should include certain tax provisions.

As described above, certain payments made in respect of swaps on U.S. equities will be considered payments of U.S. source dividend income and therefore be subject to withholding tax. This will be so even if the parties to the swap are foreign, as a "withholding agent" is defined in Reg. 1.1441-7(a)(1) to include "any person, U.S. *or foreign,* that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding" (emphasis added). [82] Modifications related to the HIRE Act are described below under "HIRE Act Protocol." [83] In addition,

notwithstanding the delivery of any representations or tax forms, "dividend equivalents" subject to withholding under Section 871(m) will have to be reported on Form 1042-S. [84]

If the swap will not cover U.S. equities, Form 1042-S and Form 1099 reporting may not apply in a "foreign to foreign" transaction even absent representations and delivery of tax forms. [85] U.S. tax representations and tax forms still may be appropriate, however, and the relevant representations and forms will depend on whether the swap income is ECI to the foreign broker-dealer.

If the foreign broker-dealer is a "Multibranch Party" and can act out of its U.S. office, the foreign broker-dealer's income could be considered ECI subject to reporting. The foreign broker-dealer should be asked to represent that "each payment received or to be received by it in connection with this Agreement will be effectively connected with its conduct of a trade or business in the United States." If this representation is provided, the Foreign Fund will report payments to the foreign broker-dealer on Form 1042-S.

Some foreign broker-dealers that can act out of U.S. and foreign offices, however, make a representation to the effect that (1) if a payment is effectively connected with the conduct of a trade or business in the U.S., it should be treated as effectively connected with the conduct of a trade or business in the U.S., and (2) if a payment is not effectively connected with the conduct of a trade or business in the U.S., the foreign broker-dealer is a "non-U.S. branch of a foreign person." This representation should be rejected, as the Foreign Fund will not know when the payment is effectively connected with the conduct of a trade or business in the U.S., and therefore will not know when to report a payment on Form 1042-S.

An alternative is for the foreign broker-dealer to represent that it will indicate in the confirmation for each transaction whether the payments related to the transaction are effectively connected with the conduct of a trade or business in the U.S. [86] Other alternatives are for the foreign broker-dealer to:

> (1) Provide a default rule in the representations that all payments should be considered effectively connected with the conduct of a trade or business in the U.S. (and therefore subject to reporting on Form 1042-S) unless indicated otherwise by the foreign broker-dealer, or
> (2) Represent that with respect to payments made to an address outside the U.S. or made by a transfer of funds to an account outside the U.S., it is a "non-U.S. branch of a foreign person," and with respect to payments made to an address within the U.S. or made by a transfer of funds to an account within the U.S., such payments will be effectively connected with its conduct of a trade or business in the U.S.

Even if the foreign broker-dealer is not a "Multibranch Party" or cannot act out of its U.S. branch, to achieve certainty in its position with respect to its nonreporting on Form 1042-S and Form 1099, the Foreign Fund should attempt to qualify for a regulatory safe harbor. It would therefore be prudent for the Foreign Fund to request a "non-U.S. branch of a foreign person" representation from the foreign broker-dealer, a representation that it should be able to make. [87] If the foreign broker-dealer will not provide this representation, the Foreign Fund should request a "foreign person" representation or the delivery of a Form W-8BEN so as not to have to address the factual question of whether the swap payments are made outside the U.S. [88]

Foreign Fund. If, as noted in discussion above under "Foreign broker-dealer," the parties have agreed to provide payee representations notwithstanding that the

transaction is "foreign to foreign," the Foreign Fund should make the applicable (corporate or partnership) representations discussed above. Even if the foreign broker-dealer will not agree to provide payee representations, the Foreign Fund might consider providing its applicable payee representations to ensure that the foreign broker-dealer does not report to the IRS payments made to the Foreign Fund. [89]

Because any interest paid to the Foreign Fund in connection with the swap will not be U.S. source, it will not be subject to U.S. withholding tax, and the portfolio interest representation will not be necessary. [90] In addition, there is no need to add the provision regarding transfers.

HIRE ACT PROTOCOL

On 8/23/10, ISDA published the 2010 HIRE Act Protocol. [91] The Protocol is an efficient way for parties to address issues raised by new Section 871(m) and Sections 1471 through 1474. If two parties have adhered to the Protocol, both outstanding and future swap agreements between the two parties are considered to be amended by the terms of the Protocol. [92] While the Protocol is intended for use without negotiation, and an adhering party may not specify additional provisions, conditions, or limitations in its Adherence Letter, [93] parties presumably may and will negotiate modifications to the Protocol in the Schedule. [94]

Swap counterparties will want to structure their swaps on U.S. equities carefully to prevent them from being considered "specified notional principal contracts" or from being recharacterized as something other than notional principal contracts under general tax principles. The following discussion does not address such issues, and is instead limited to describing the key terms of the Protocol.

Indemnifiable Tax/Gross-Up

As described above, under the ISDA Master Agreement the payer of a swap payment generally must gross up the payee in respect of any "indemnifiable tax." [95] In certain instances, such as if a tax and corresponding gross-up is required due to a change in law, the payer is permitted to terminate the contact. [96] Until the enactment of the HIRE Act, U.S. withholding tax on swaps was not expected, and short parties therefore did not expect to be required to gross up any swap payments for U.S. withholding tax. The Protocol addresses the new withholding tax on "dividend equivalents" imposed by the HIRE Act by carving out "dividend equivalent tax" (i.e., "any tax imposed on payments treated as dividends from sources within the United States under Section 871(m)") [97] from the definition of "indemnifiable tax." [98] Therefore, a short party will not be required to gross up a long party in respect of tax imposed on a "dividend equivalent." [99]

The Protocol also amends section 2(d)(ii) of the ISDA Master Agreement. That section generally provides that if a payer was required to, but did not, withhold from a payment with respect to which it would not be required to gross up the payee, and a liability for such tax is assessed against the payer, then the payee indemnifies the payer for such tax. The section applies to amounts in respect of which "deduction or withholding" is required, but Section 871(m) imposes tax on a "gross" payment basis and applies even if there is no net payment from which to withhold. [100] The Protocol therefore amends section 2(d)(ii) of the ISDA Master Agreement to provide that any requirement to remit tax pursuant to Section 871(m) is treated as a requirement to deduct or withhold tax for purposes of section 2(d)(ii) of the ISDA Master Agreement. [101]

Termination Events

The Protocol provides for additional termination events and amends certain existing termination events. First, if a swap payment becomes subject to a dividend equivalent tax by reason of a "change in tax law" [102] occurring after the transaction is entered into (a "withholding imposition action"), [103] both the long party and the short party generally have the option to terminate the swap. [104]

The long party may exercise this right so as not to receive payments net of withholding tax, and the short party may exercise this right if its systems are not set up to address withholding, or so as not have to deal with the administrative burden of withholding. The short party exercising this termination right is generally required to provide at least ten business days' notice prior to the termination date (or less if the withholding would be required less than ten days after the withholding imposition action), and generally must provide for termination not later than 18 months following the withholding imposition action if such action occurred before 3/18/12 and not later than three months following the withholding imposition action if such action occurred after 3/17/12. [105]

The Protocol also amends the definition of "tax event." The amendment does not relate specifically to the HIRE Act provisions, but to the audit environment in general, in which equity swaps are being scrutinized. As explained on the HIRE Act Protocol Market Education Call on 8/27/10, [106] this amendment addresses the recent development that the IRS is challenging equity swaps through an aggressive audit process, something that was not contemplated at the time the definition of "tax event" was first formulated, as opposed to issuing rulings and guidance.

The tax event amendment applies only to equity swaps, and only to swaps entered into after the date that the Protocol has become effective in respect of the parties (i.e., it affects only future swaps, not outstanding swaps). [107] The amendment generally provides that an "action taken by a taxing authority" as used in the definition of "tax event" will be considered as having occurred in respect of a transaction if the IRS provides written notice to a swaps dealer or hedge fund of a tax assessment, or of an intention to assess tax, with respect to an issue identified as a "Tier 1" issue, [108] provided that:

> (1) The transaction covered by the notice is "substantially similar" to the parties' transaction,
> (2) The tax subject to the notice would be an "indemnifiable tax" with respect to the transaction, and
> (3) A notice explaining the circumstances of the assessment or proposed assessment is provided promptly to the other party. [109]

In addition, the "tax event" definition requirement that there be a substantial likelihood that a party will be required to gross up in respect of an "indemnifiable tax" will be deemed to be satisfied if a party determines in good faith that, due to the IRS notice described above, the Service is likely to view the transaction as "substantially similar" to the transaction in the notice. [110] Finally, "substantially similar" for these purposes means any transaction that is expected to obtain the same or similar tax consequences and that is either factually similar or based on the same or similar tax strategy. [111]

Payee Representations

Because a U.S. equity swap has the potential to produce U.S. source dividend income if the swap is a "specified notional principal contract," swap payments could be

"withholdable payments" subject to withholding under Section 1471 or 1472. Such withholding would not be required if the payee complies with certain information reporting requirements.

The Protocol therefore amends the ISDA Master Agreement so that, effective 9/14/10, each foreign [112] party represents, as of the time any "withholdable payment" is made after 2012, that it meets the requirements of Section 1471(b) if it is a "foreign financial institution," or Section 1472(b)(1) (unless an exception applies) if it is a non-financial foreign entity. [113] Presumably, Foreign Funds will enter into these agreements to protect their U.S. source interest and dividend income, as well as their gross proceeds from dispositions of property of a type that can produce U.S. source interest or dividend income, from withholding. [114] This representation could be relevant even if the swap does not cover U.S. equities, because the swap could produce U.S. source interest income payable to a foreign party if the foreign party makes a "significant nonperiodic payment" to the other party.

Even if tax imposed under Section 871(m) is carved out of the definition of "indemnifiable tax" so that a short party will not be economically responsible for such tax, a short party may not want to enter into an agreement if it knows that a swap will be subject to such tax and that it will be required to withhold from an amount treated as a "dividend equivalent." The Protocol therefore adds that if a transaction provides for one or more amounts that are treated as a "dividend equivalent," [115] then a foreign long party (with respect to which swap income is not ECI) [116] represents that it has not "crossed in" to and will not "cross out" of the transaction, actions that are within the long party's control. [117] This representation will provide some comfort to the short party that it is not entering into a "specified notional principal contact."

In addition, the foreign long party represents that (1) if the opening price on the transaction is determined by reference to "market on close" (MOC) or "market on open" (MOO) on a particular day or days, then it has not "in connection with" entering into the transaction put in a sell order for the underlying equity at MOC or MOO on such day or days and (2) if the closing price on the transaction is or will be determined by reference to MOC or MOO on a particular day or days, then it will not "in connection with" the termination of the transaction put in a buy order for the underlying equity at MOC or MOO on such day or days. [118] As explained on the HIRE Act Protocol Market Education Call on 8/27/10, this representation addresses the "indirect" cross in/cross out concern. [119]

If the opening swap price is based, for example, on MOC, the short party presumably hedged by purchasing the underlying equity at MOC. If at the same time the long party sold the underlying equity into the market at MOC, there is a concern that the transactions will be stepped together to be considered a cross in. The representation enables the short party—the withholding agent against whom the IRS may impose tax—to argue in reliance on the representation that it did not know or have reason to know that the swap was a "specified notional principal contract" subject to withholding as a result of any indirect cross in or cross out. [120]

Other Provisions

The Protocol provides that tax imposed under Section 871(m) (or tax imposed on a foreign financial institution that has made an election under Section 1471(b)(3)) is carved out from the *payer* representation (which otherwise provides that the payer make all payments under the swap free of deduction or withholding on account of any tax). [121] This is necessary in order to make the representation factually correct. The payer

representation serves only a due diligence function, and does not affect the parties' gross-up obligations or termination rights. [122]

Finally, the Protocol amends section 3 of the Schedule to require each party to provide whatever documentation is required under Section 1471(b) or Section 1472(b)(1) and any other documentation reasonably requested by the other party as it relates thereto. [123] This documentation will allow the payer to make payments to "foreign financial institution" or "non-financial foreign entity" payees without withholding. The documentation must be provided on or before the forms are prescribed by law to be provided, but not before the form and contents of such documentation are made known by the IRS. [124]

CONCLUSION

Negotiating swaps on ISDA Master Agreements requires familiarity with a myriad of withholding and reporting rules. Recent legislation that has yet to be clarified, as well as other substantive and technical ambiguities, add complexity. Practitioners negotiating swaps on behalf of foreign hedge funds in particular should slow down and carefully consider the representations and other provisions that they request from and deliver to counterparties in an ISDA Master Agreement Schedule.

Practice Notes

Many hedge funds and practitioners interpret the non-U.S. branch of a foreign person representation as essentially a representation that the swap income is not ECI, which is a representation they feel comfortable making. Others, however, hesitate in making this representation. A Foreign Hedge Fund Corporation that provides a Form W-8BEN has a strong position that swap payments made to it should not be reported on Form 1042-S, notwithstanding that it does not provide a "non-U.S. branch of a foreign person" representation. It may be helpful, though, also to provide a representation stating that income from the swap is not ECI.

[1]

The following discussion addresses, and all references to "swaps" herein should be treated as referring to, swaps that satisfy the definition of "notional principal contracts" under Reg. 1.863-7(a)(1) or 1.446-3(c)(1)(i), and that are not recharacterized as a leveraged acquisition of property under general principles of tax law.

[2]

See Harding, *Mastering the ISDA® Master Agreements (1992 and 2002): A Practical Guide for Negotiation* (Financial Times Prentice Hall, 3d ed., 2010), page 24 ("For many years [the 1992 version of the ISDA Master Agreement] was the pre-eminent, market standard *multiproduct* Master Agreement for parties who plan to enter into a series of OTC derivatives transactions with each other. However, the 2002 ISDA Master Agreement is now catching up following the bankruptcy of Lehman Brothers in September 2008").

[3]

The 2002 ISDA Master Agreement defines "indemnifiable tax" as "any Tax other than a Tax that would not be imposed in respect of a payment under this Agreement but for a present or former connection between the jurisdiction of the government or taxation authority imposing such Tax and the recipient of such payment or a person related to such recipient (including, without limitation, a connection arising from such recipient or related person being or having been a citizen or resident of such jurisdiction, or being or having been organised, present or engaged in a trade or business in such jurisdiction, or having or having had a permanent establishment or fixed place of business in such jurisdiction, but excluding a connection arising solely from such recipient or related

person having executed, delivered, performed its obligations or received a payment under, or enforced, this Agreement or a Credit Support Document)."

[4] 2002 ISDA Master Agreement, section 2(d). There are exceptions to the gross-up requirement in certain circumstances. See *id.,* sections 2(d)(i)(4)(A) and (B).

[5] *Id.,* sections 5(b)(iii) and (iv); 6(b).

[6] The 2002 ISDA Master Agreement defines "change in tax law" as "the enactment, promulgation, execution or ratification of, or any change in or amendment to, any law (or in the application or official interpretation of any law) that occurs after the parties enter into the relevant Transaction."

[7] Reg. 1.1441-4(a)(3).

[8] See Sections 871(a)(1)(A), 881(a)(1), and 1441(a) and (b).

[9] See TD 8734, 10/6/97 ("Commentators have questioned whether it is appropriate to treat income from notional principal contracts as FDAP income, particularly since it is unclear at the outset whether the arrangement will generate any income. The IRS and Treasury believe that the statute contemplates very few exceptions to the concept of FDAP, and the only clear exception is for gain from the disposition of property. Income from notional principal contracts is not gain from the disposition of property, nor is it the equivalent of gain").

[10] Reg. 1.863-7(b).

[11] Section 988(a)(3)(B)(i). There is some ambiguity with regard to the source of swap payments to U.S. partnerships with foreign partners. See, e.g., Reich, "Taxing Foreign Investors' Portfolio Investments: Developments and Discontinuities," 79 Tax Notes 1465 (1998), fn. 71; Conway, "Hedge Fund Structures and Certain Tax Issues for Hedge Funds," in Jordan, Kawata, and Landa, *Advising Private Funds: A Comprehensive Guide to Representing Hedge Funds, Private Equity Funds and Their Advisers* (Thomson Reuters/West, 2010), §28:11. For this reason, some hedge funds use a foreign entity treated as a partnership for U.S. federal income tax purposes, and not a U.S. partnership, as the master fund in a "master/feeder" structure. See, e.g., *id.*; Statement of Leon M. Metzger, Former Vice Chairman and Chief Administration Officer of Paloma Partners Management Company, Testimony Before the Full Committee of the House Committee on Ways and Means, 9/6/07, available at waysandmeans.house.gov/Hearings/Testimony.aspx?TID=1810.

[12] Most non-U.S. jurisdictions do not impose withholding tax on swap payments. See Harding, *supra* note 2, page 515. An ISDA Master Agreement negotiator might become aware of an issue in this regard, though, if a counterparty did not provide the standard "payer representation" stating that payments made by the counterparty will not be reduced for tax. In that event, additional representations and/or documentation might need to be provided to avoid the imposition of a foreign withholding tax.

[13] Reg. 1.446-3(g)(4). With respect to what is considered a "significant" payment, see Reg. 1.446-3(g)(6), Examples 2 and 3.

[14] Reg. 1.446-3(g)(4). Interest also may be paid on a swap in respect of collateral posted by, or as a penalty for late payment by, a party.

[15] Section 861(a)(1).

[16]

Section 1441.

[17]

Sections 871(h) and 881(c).

[18]

U.S. source interest income also is not subject to withholding if it is effectively connected with the conduct of a trade or business in the U.S. See Sections 871(a) and 881(a); Reg. 1.1441-4(a)(2)(i). Most foreign hedge funds take the position, though, that their income is not effectively connected with the conduct of a trade or business in the U.S.

[19]

The Regulation presumes swap income is ECI "if the income is paid to, or to the account of, a qualified business unit of a foreign person located in the United States or, if the payment is paid to, or to the account of, a qualified business unit of a foreign person located outside the United States, the withholding agent knows, or has reason to know, the payment is effectively connected with the conduct of a trade or business within the United States."

[20]

See discussion in the text, below, regarding the delivery of this representation in the foreign partnership context.

[21]

Reg. 1.1441-4(a)(3)(ii).

[22]

Reg. 1.1461-1(c)(2)(ii)(F).

[23]

Reg. 1.1461-1(c)(2)(i)(B).

[24]

Reg. 1.6041-1(d)(5). Exceptions also are provided for payments made outside the U.S. by non-U.S. payers, by U.S. payers that are not U.S. persons, or by foreign branches of non-U.S. banks. *Id.*

[25]

Reg. 1.6049-4(c)(1)(ii).

[26]

Reg. 1.6041-1(d)(5).

[27]

Reg. 1.6041-4(a)(4). See the discussion in the text, below, regarding the delivery of this representation in the foreign partnership context.

[28]

Regs. 1.6041-4(a)(1), 1.1441-1(e)(1)(ii), and 1.6049-5(d).

[29]

Section 3406(b)(3)(A).

[30]

See Section 3406(a).

[31]

See Reg. 31.3406(h)-3.

[32]

Reg. 31.3406(d)-1(d).

[33]

Section 871(l) as enacted by the HIRE Act was redesignated Section 871(m) pursuant to P.L. 111-226, 8/10/10, for years beginning after 2010.

[34]

Section 871(m)(2).

[35]

For these purposes, an index or a fixed basket of securities is treated as a single security; see Section 871(m)(4)(C). The Joint Committee Technical Explanation of the HIRE Act provides, however, that, "[i]n applying this rule, it is intended that such a security will be deemed to be regularly traded on an established securities market if

every component of such index or fixed basket is a security that is readily tradable on an established securities market." 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), 2/23/10.

[36] Section 871(m)(3)(A).

[37] Section 871(m)(3)(B).

[38] HIRE Act, section 501(d)(1).

[39] Under Section 1471(d)(4), a "foreign financial institution" is any "financial institution" that is a "foreign entity." A "foreign entity" is an entity that is not a U.S. person, under Section 1473(5). Section 1471(d)(5) provides that a "financial institution" is an entity that (1) accepts deposits in the ordinary course of a banking or similar business, (2) as a substantial portion of its business holds financial assets for the account of others, or (3) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities (as defined in Section 475(c)(2) without regard to the last sentence thereof), partnership interests, commodities (as defined in Section 475(e)(2)), or any interest (including a futures or forward contract or option) in such securities, partnership interests, or commodities. Foreign hedge funds will qualify under (3) and foreign swap dealers will qualify under (1) or (2).

[40] Section 1473(1).

[41] In addition, because a "withholdable payment" for purposes of Section 1471 includes gross proceeds from the sale or other disposition of property of a type that can produce U.S. source interest or U.S. source dividends, a foreign counterparty's gross proceeds from the sale or unwind of a swap that produces U.S. source interest (as a result of a "significant nonperiodic payment") or U.S. source dividends (as a result of Section 871(m)) may be subject to 30% withholding tax under Section 1471(a) unless the requirements of Section 1471(b) are met. See Kopp and Kim, "Nonrefundable U.S. Withholding Tax Imposed on Foreign Investment Vehicles That Fail to Report," 8 J. Tax'n Fin'l Prods. 4 (2010), fn. 48.

[42] Pursuant to section 3 of the ISDA Master Agreement, the payee tax representations are considered as being made at all times until the termination of the agreement.

[43] Reg. 1.6049-4(c)(1)(ii)(M).

[44] Reg. 1.6049-4(c)(1)(ii)(Q).

[45] Bills have been introduced in Congress that would repeal this new section. See section 2 of the Small Business Paperwork Mandate Elimination Act, S. 3578 and H.R. 5141, 111th Cong. (2010). See also S. Amdt. 4455, S. Amdt. 4513, and S. Amdt. 4531 to the Small Business Jobs and Credit Act of 2010, H.R. 5297, 111th Cong. (2010).

[46] In general, Section 6041 requires information returns to be made by "persons engaged in a trade or business and making payment in the course of such trade or business." Many hedge funds take the position that they are in a trade or business for purposes of Section 162, and therefore may be considered to be engaged in a trade or business for purposes of Section 6041. Regarding whether a hedge fund is in a trade or business for purposes of Section 162 and other Code sections, see "Are Hedge Funds in a Trade or Business?," 114 Tax Notes 139 (1/15/07); Shapiro, "Private Securities Partnerships—The Trade or Business Issue Examined," 56 Tax Notes 85 (7/6/92); Shapiro and Rubenstein,

"Deductibility of Private Securities Partnership Expenses After Mayer," 95 TNT 52-56; Schwartz, "How Many Trades Must a Trader Make To Be in the Trading Business?," 22 Va. Tax Rev. 395 (Winter 2003).

47

Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals,* February 2010.

48

The next two sentences of that paragraph both also focus on the exception from information reporting for payments to corporations. *Id.* See also Congressional Research Service, *Form 1099 Information Reporting Requirements as Modified by the Patient Protection and Affordable Care Act* (8/6/10) ("[f]irst, payments to corporations will no longer be automatically exempt from reporting requirements *by virtue of the payee's corporate status,* despite existing regulations to the contrary" (emphasis added)).

49

Until the scope of Section 6041(h) is clarified, a Foreign Hedge Fund Corporation might consider asking the U.S. broker-dealer to deliver a complete and accurate Form W-9 or to provide its taxpayer identification number in a representation so that the Foreign Hedge Fund Corporation is certain that it is not required to backup withhold. A U.S. broker-dealer should have an incentive to provide a Form W-9 or its taxpayer identification number due to the uncertainty as to whether backup withholding, which is not an "indemnifiable tax" subject to a gross-up under the ISDA Master Agreement, is required, and the ease and lack of risk in providing a Form W-9 or taxpayer identification number. With respect to backup withholding not being an "indemnifiable tax," see Gooch and Klein, *Documentation for Derivatives: Annotated Sample Agreements and Confirmations for Swaps and Other Over-the-Counter Transactions* (Euromoney Books, 4th ed. 2002), page 356 ("Generally, the risk of U.S. backup withholding will be allocable to the payee, since backup withholding is imposed because of a connection between the taxing jurisdiction—the United States—and the payee, and taxes of this kind are conventionally excluded from those that give rise to a gross-up obligation on the part of the payer, referred to in ISDA documentation as 'Indemnifiable Taxes'").

50

See Prop. Reg. 1.864(b)-1.

51

TD 8734, *supra* note 9 (emphasis added).

52

See Harding, *supra* note 2, page 365 ("The same result could be achieved by having the non-US taxpayer represent that no payments made to it constitute effectively connected income for it. Although this would suggest that no reporting would therefore be required if it is not ECI, it would not qualify for any regulatory safe harbour under the regulations").

53

IRM 4.10.21.8.7.6 (last revised 7/29/08) ("The ECI presumption may be rebutted by a withholding certificate representing that the payments are not effectively connected with the conduct of a U.S. trade or business. Instead of a withholding tax certificate, a payee may represent in a master agreement governing the transactions in NPCs between the parties that the counterparty is a U.S. person or a non-U.S. branch of a foreign person"); Instructions for the Requester of Forms W-8BEN, W-8ECI, W-8EXP, and W-8IMY (revised May 2006), available at www.irs.gov/pub/irs-pdf/iw8.pdf ("However, a payment is not treated as effectively connected with the conduct of a trade or business within the United States if the payee provides a Form W-8BEN representing that the income is not effectively connected with a U.S. trade or business or makes a representation in a master agreement ... or in the confirmation ... that the payee is a U.S. person or a non-U.S. branch of a foreign person"); IRS Pub. 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities: For use in 2010,* page 16, available at www.irs.gov/pub/irs-pdf/p515.pdf ("You do not need to treat notional principal contract income as effectively connected if you receive a Form W-8BEN that represents that the income is not effectively connected

with the conduct of a U.S. trade or business or if the payee provides a representation in a master agreement or in the confirmation on the particular notional principal contract transaction that the payee is a U.S. person or a non-U.S. branch of a foreign person").
[54]

Connors, "Withholding Obligations for Nonresident Aliens," in Levey, ed., *U.S. Taxation of Foreign-Controlled Businesses* (Thomson Reuters/WG&L), ¶17.14[10] ("The effectively connected income presumption may be rebutted by providing the withholding agent with a withholding certificate representing that the payments are not effectively connected with the conduct of a U.S. trade or business. No reporting is required on a Form 1042-S for these amounts. Instead of a withholding certificate, a payee may represent in a master agreement governing the transactions in NPCs between the parties that the counterparty is a U.S. person or is a non-U.S. office of a foreign person"); Halphen, "Revised Withholding Regulations—A Race to the Finish?," 88 Tax Notes 245 (7/10/00) ("A counterparty may rebut the presumption that the swap payment is effectively connected with a U.S. trade or business by furnishing documentation to the payer that the payment is not connected. The representation may be provided by way of a Form W-8BEN furnished to the payer or by way of a representation inserted in the master swap agreement (or the confirmation ticket) that governs the transaction"); "ISDA Provides Language to Clarify Withholding Requirements, Exemptions in Multicurrency Master," 15 J. Tax'n Fin. Instr. 52 (Jan/Feb 2002) ("Reporting under Form 1042-S is not required if the payee provides the withholding agent with a withholding certificate or if the payee represents in a master agreement, or a Schedule thereto, that the payee is a U.S. person or a non-U.S. branch of a foreign person"). See also Letter from Patti McClanahan, Managing Director, SIFMA, to Glenn Kirkland, IRS Reports Clearance Officer, dated 6/29/07, available at www.sifma.org/regulatory/comment_letters/47326787.pdf ("The industry, as allowed by regulation, presumes that all NPC transactions involving a counterparty that has provided a Form W-8BEN are NOT effectively connected with a US trade or business (unless one of the ECI exceptions exist). The request for a counterparty to provide an additional statement identifying those NPCs the income from which is not effectively connected in those cases where the counterparty has already identified itself as foreign by providing a Form W-8BEN is redundant").
[55]

Former Reg. 1.1441-4(a)(4)(3)(i) stated that, "[e]xcept as otherwise provided in paragraph (a)(3)(ii) of this section, a withholding agent must so treat the income [as ECI paid to a foreign person] unless it can reliably associate the payment with a withholding certificate upon which it can rely to treat the payment as an amount that is not effectively connected...."
[56]

See Harding, *supra* note 2, pages 366-367 ("Therefore foreign payees making the representation in Part 2(b)(iv) or (v) to avoid IRS Form 1042 will also avoid IRS Form 1099 reporting.... If the payee gives the Part 2(b)(iv) representation, the payer generally will not need to report payments on either IRS Form 1042-S or IRS Form 1099"); *Memorandum: New US Tax Representations for Schedule to ISDA Master Agreement,* available at www.isda.org/whatsnew/pdf/Tax-Memo-Final.pdf ("Memorandum") ("Thus, foreign payees providing the new representations in paragraphs (B) and (C) to avoid Form 1042-S information reporting also will be exempt from Form 1099 reporting"); *Explanatory Note for New US Tax Representations,* available at www.isda.org/whatsnew/pdf/Tax-Explanation-NoteFinal.pdf ("If the payee provides this representation, the payer generally will not be required to report payments on either Form 1042-S or Form 1099").
[57]

The ambiguity created by new Section 6041(h) described in the text, above, applies here as well. In this case, does Section 6041(h) override the exemption from information reporting in respect of payments to corporations that provide the "foreign person" representation just because the foreign person also happens to be a corporation? Another exemption from information reporting applies in the case of payments made to a foreign

payee that provides a Form W-8BEN; see Reg. 1.6041-4(a)(1). Does Section 6041(h) override that exemption as well? As noted in the text, above, the better reading of Section 6041(h) is that Section 6041(h) overrides only the exemption for corporations, and therefore does not override the exemptions for foreign persons providing the "foreign person" representation or delivering a Form W-8BEN. It is especially unlikely that Congress intended Section 6041(h) to override the exceptions to information reporting and backup withholding applicable to foreign persons given that Section 3406 was enacted largely to prevent domestic taxpayers from failing to pay taxes on certain types of income. See Kuntz and Peroni, *U.S. International Taxation* (Thomson Reuters/WG&L, 2005), ¶C2.08[1]. Until Regulations or other guidance clarifies the scope of Section 6041(h), however, a Foreign Hedge Fund Corporation wanting to ensure that a counterparty is not required to backup withhold might consider making the "foreign person" representation and providing a Form W-8BEN with a taxpayer identification number. (Foreign hedge funds often obtain U.S. taxpayer identification numbers in order to establish bank accounts in the U.S. Taxpayer identification numbers generally are required on a Form W-8 only in certain situations. See Reg. 1.1441-1(e)(4)(vii).)

58

See International Swaps and Derivatives Association, Inc., *User's Guide to the ISDA 2002 Master Agreement* (2003 ed.), page 61 ("User's Guide") ("Because there is no bright-line test [as to] whether a payment is 'significant,' Transactions with up-front (or other non-periodic) payments *to* a U.S. party *from* a non-U.S. party should be reviewed by tax counsel to determine whether they could be loans for U.S. tax purposes. If the only up-front payment is *by* a U.S. party, however, no review is necessary because interest paid *to* a U.S. person is not subject to withholding") (emphasis in original).

59

As observed in note 18, *supra,* U.S. source interest is also not subject to withholding if it is effectively connected with the conduct of a trade or business in the U.S., but most foreign hedge funds take the position that their income is not ECI.

60

See User's Guide, *supra* note 58, page 62 ("U.S. Internal Revenue Service rules do not expressly authorise reliance on such representations and ISDA has not provided sample language"); Memorandum, *supra* note 56 (same).

61

See Harding, *supra* note 2, page 361 ("If there is any possibility of an ownership question, the US party can eliminate this risk by requiring that the non-US taxpayer represent that it is not a 10% shareholder").

62

See Sections 871(h) and 881(c). See also Swartz, *ABCs of Cross-Border Derivatives,* 897 PLI 983 (2009) (providing a sample portfolio interest representation); Gooch and Klein, *supra* note 49, page 914 (same).

63

See Sections 871(h)(2)(B)(ii) and 881(c)(2)(B)(ii); Reg. 1.871-14(c)(2).

64

A Form W-8 is required in order for the portfolio interest exception to apply, and it is therefore reasonable for the U.S. broker-dealer to request such form.

65

Although a payer generally must gross up a payee in respect of an "indemnifiable tax" pursuant to section 2(d)(i)(4) of the 2002 ISDA Master Agreement, a payee is not entitled to a gross-up in respect of an "indemnifiable tax" (and therefore bears the tax burden) if the payee made a tax representation that fails to be true (other than as a result of certain changes in law and other similar legal developments) and the "indemnifiable tax" would not have been imposed had the representation been true. See 2002 ISDA Master Agreement, section 2(d)(i)(4)(B); User's Guide, *supra* note 58, pages 41, 49-52; Gooch and Klein, *supra* note 49, pages 812-813.

The Foreign Hedge Fund Corporation also might resist making the portfolio interest representation on the grounds that such representation is relevant only if the Foreign

Hedge Fund Corporation receives U.S. source interest as a result of making a significant nonperiodic payment, and such a payment may not be contemplated in the transaction at hand. This objection is not reasonable, however, as an ISDA Master Agreement may be used for numerous transactions, and should therefore include provisions for a variety of situations that could arise.

[66] See 2002 ISDA Master Agreement, section 2(d). A foreign hedge fund may receive interest payments on a swap in respect of collateral posted with the counterparty. The terms of collateral posting on a swap are governed by the Credit Support Annex executed by the parties. Paragraph 10(b) of the 1994 ISDA Credit Support Annex (New York Law) provides that the Pledgor is responsible for all taxes imposed on the collateral. This provision of the Credit Support Annex appears to override the gross-up provisions of the ISDA Master Agreement. If a Foreign Hedge Fund Corporation is concerned that the broker-dealer may withhold from payments of interest on the collateral without a portfolio interest representation, the Foreign Hedge Fund Corporation might agree to make, or might even offer up, a portfolio interest representation. A Foreign Hedge Fund Corporation with significant negotiating leverage can attempt to amend paragraph 10(b) of the Credit Support Annex by providing in paragraph 13 of the Annex that notwithstanding paragraph 10(b) of the Credit Support Annex, section 2(d) of the ISDA Master Agreement will apply to any "indemnifiable tax" imposed on a payment to the Pledgor described in paragraph 6(d) (the paragraph governing distributions and interest on the collateral) of the Credit Support Annex.

[67] This assumes that the representation is factually accurate, as is likely to be the case.

[68] Sections 871(h)(2) and 881(c)(2).

[69] Reg. 5f.103-1(c)(1)(ii).

[70] Reg. 5f.103-1(c)(2).

[71] See Harding, *supra* note 2, page 360 ("The ISDA Master Agreement is generally considered to meet the registered form requirements"); User's Guide, *supra* note 58, page 59 ("Most tax practitioners believe that a typical Transaction documented under the 2002 Agreement (and its predecessor, the 1992 Agreement) is in registered form because in the classic Transaction, neither party can transfer its interest in the Transaction without the consent of the other party (and consent is typically given only in connection with a current proposed transfer to a specified transferee)"); Shapiro and Feder, "Observations on the Proposed Contingent Swap Regulations," 45 Tax Mgt. Memo. 333 (2004) ("Many practitioners take the position that swaps are issued in registered form because they generally are not freely transferable").

[72] See User's Guide, *supra* note 58, page 59 ("However, the U.S. Internal Revenue Service has not provided any guidance on this point and it is also possible that consent may be given in a manner in which it would be less clear that the registration requirements are satisfied (e.g., the giving of blanket consent for future transfers to a class of transferees in which the identity of the specific transferee is not specified)").

[73] See Biondo and Rosier, "The Effect of the Proposed Swap Regulations on the Hedge Fund Industry: Goodbye to Total Return Swaps?," 103 Tax Notes 1171 (5/31/04) (suggesting such an amendment to the transfer provision); Bloomfield and Eichler, "Hard Work Produces 2002 ISDA Master Agreement: New Tax Provisions Reflected," 4 Derivatives Report 7 (March 2003) (same), available at www.stroock.com/SiteFiles/Pub174.pdf. See also Memorandum, *supra* note 56 ("Parties often take the position that an agreement is in registered form if the foreign party's

rights to receive payments can be transferred only with notice to the payer").

[74] Reg. 1.1461-1(c)(2)(B).

[75] See User's Guide, *supra* note 58, page 61 (noting that ISDA provided sample representations only for "withholding foreign partnerships" and that persons making payments to "nonwithholding foreign partnerships" should consult tax counsel as to the representations and tax forms required to avoid information reporting and backup withholding); Memorandum, *supra* note 56 (same); "Explanatory Note for New US Tax Representations," available at www.isda.org/whatsnew/pdf/Tax-Explanation-NoteFinal.pdf ("Application of US tax reporting and withholding rules to payments to a foreign (non-US) partnership or trust depends on the tax status of the partnership or trust (including whether it qualifies as a withholding foreign partnership or withholding foreign trust) and on the status of its partners or beneficiaries. Parties to a transaction involving payments to a foreign partnership or trust are urged to consult with tax counsel regarding reliance on the representations in paragraphs (B), (C) and (D)").

[76] The 1997 version of the Section 1441 final Regulations stated that the ECI presumption is rebutted if "the *payee* provides a representation ... that the *counterparty* is a U.S. person or a non-U.S. branch of a foreign person" (emphasis added). The regulatory safe harbor in the 1997 Regulations applied only to financial institutions (which the drafters may have assumed were corporations), while the current regulatory safe harbor applies to all payees.

[77] Regs. 1.1441-1(c)(12) and 1.1441-5(c)(1).

[78] A representation in respect of the partners could state that each of the partners is either a "U.S. person" or a "foreign person," but, because information reporting would be required in respect of the U.S. partners, as described below, such a representation would make sense only if the Foreign Hedge Fund Partnership also provided the percentages owned by the U.S. partners and the foreign partners, respectively.

[79] If the Foreign Hedge Fund Partnership is providing a Form W-8IMY with the applicable attachments, though, a representation in respect of its partners would appear unnecessary, as the delivery of the Form W-8IMY and the attachments would provide essentially the same information to the counterparty.

[80] Reg. 1.1461-1(c)(2)(B).

[81] The ECI presumption in Reg. 1.1441-4(a)(3)(i) (requiring reporting on Form 1042-S) applies only if "the income is paid to, or to the account of, a qualified business unit of a foreign person located in the United States or, if the payment is paid to, or to the account of, a qualified business unit of a foreign person located outside the United States, the withholding agent knows, or has reason to know, the payment is effectively connected with the conduct of a trade or business within the United States." Payments to the foreign broker-dealer in a "foreign to foreign" swap typically will be made outside the U.S., and the Foreign Fund typically will not have reason to know that such payments are ECI (unless the foreign broker-dealer is a "Multibranch Party" that can act out of a U.S. office). In addition, Reg. 1.6041-1(d)(5) (regarding payments made outside the U.S.) or Reg. 1.6041-4(a)(2) (regarding non-U.S. source payments made by a non-U.S. payer outside the U.S.) typically will apply in "foreign to foreign" transactions to prevent the imposition of information reporting under Section 6041.

[82] See Leeds, "When the Other Shoe Falls: IRS Notice 2010-46 Restricts the Application of Notice 97-66 for Cross-Border Securities Loans," BNA Daily Tax Report, 6/3/10, page J-1 ("The applicable regulations do not require that the withholding agent otherwise be

subject to jurisdiction. Although it can be argued that the regulations are overbroad and attempt to impose withholding obligations on persons without U.S. contacts, we do not know of any instance in which a foreign person has challenged the withholding rules as being an extraterritorial assertion of taxing authorities").

83

One of the representations described under "HIRE Act Protocol" (in the text, below) is deemed to be made only by parties that make a representation substantially equivalent to the "non-U.S. branch of a foreign person" representation or the "foreign person" representation. See note 112, *infra,* and the accompanying text.

84

Form 1042-S must be filed in respect of amounts subject to withholding by a "withholding agent"; see Reg. 1.1461-1(b)(1). As noted above, a foreign person can be a withholding agent.
Reg. 1.1461-1(c)(2)(ii)(F) (providing an exception to Form 1042-S reporting for amounts paid on a swap that are not ECI or not treated as ECI) should not exempt a "dividend equivalent" from having to be reported. Pursuant to Section 871(m)(1), a "dividend equivalent" is treated as a dividend (and therefore not as an amount paid on a swap) for purposes of Chapter 3 of the Code, which includes Section 1461.

85

See note 81, *supra.*

86

See Swartz, *supra* note 62, for an example of such a representation.

87

Any interest paid in connection with the swap also would not be subject to reporting on Form 1042-S because it would not be U.S. source. See Reg. 1.1461-1(c)(2).

88

See Reg. 1.6049-5(e).

89

Nevertheless, as noted in the text, above, a "dividend equivalent" will be subject to reporting on Form 1042-S notwithstanding the delivery of representations and tax forms by the Foreign Fund.

90

If payments made to the foreign broker-dealer are ECI, however, interest payments made by the foreign broker-dealer to the Foreign Fund will be treated as U.S. source income under Section 884(f) and therefore subject to withholding. In that event, the Foreign Fund may be asked to provide the applicable portfolio interest representation and the transfer provision discussed in the text, above. See notes 64-67, *supra,* and the accompanying text, as well as the text preceding note 80, regarding whether the Foreign Fund should agree to provide the portfolio interest representation, and the form of such representation.

91

The Protocol and related documentation are available at www.isda.org/isda2010hireactprot/hireactprot.html. At the time this article was being finalized for publication, the ISDA North America Tax Committee was considering whether certain amendments to the Protocol should be made, or whether certain standardized language should be made available, in respect of swaps entered into by foreign dealers. Because neither the form nor the content of such potential modifications has been agreed to or finalized as of this time, the following discussion does not address amendments to the Protocol that may be made or standardized language that may be made available.

92

See Protocol, definition of "Covered Master Agreement."

93

Protocol, section 2(c).

94

See *id.,* section 4(c).

95

2002 ISDA Master Agreement, section 2(d).

[96]

Id., section 5(b)(3).

[97]

Protocol, Attachment, section 4.

[98]

Id., section 5. The Protocol also carves out taxes imposed pursuant to Section 1471 with respect to a payee that has made an election under Section 1471(b)(3) (in which event the payee has elected to be withheld upon in respect of certain payments). *Id.*

[99]

Foreign Funds that are long parties might resist (and attempt to renegotiate in the Schedule) this carve-out from the definition of "indemnifiable tax." Commentators have noted that the concept underlying the ISDA Master Agreement provisions is that the payee is protected and should receive the amount that is specified in the applicable swap confirmation. See Johnson, "Payee Tax Representations & The ISDA Master Agreement" (7/16/01), available at www.derivativesweek.com/Article.aspx?articleID=1245982&HideRelated=1&SearchResult=1 ("The policy behind the provision in the ISDA Master Agreement is that the foreign payee should receive the amount calculated under the terms of the confirmation ... without any reduction for tax withholding"); Harding, *supra* note 2, page 511 ("However, the basic concept is that notwithstanding a withholding tax charge on the payer, the payee should be protected and entitled to receive the amount he expected from the payer and which is stated in the Confirmation"). Foreign Funds may argue that this policy should apply equally to taxes imposed under Sections 871(m) and 1471. It is unlikely, though, that any such resistance, even by Foreign Funds with significant negotiating leverage, will be successful. Broker-dealers are likely to maintain that they should not be responsible for any tax imposed under Section 871(m) or under Section 1471, as they are merely providing services to the Foreign Fund in facilitating its transactions, and that it is the Foreign Fund's responsibility to structure the transaction so that no tax is imposed.

[100]

Section 871(m)(5).

[101]

Protocol, Attachment, section 1.

[102]

See note 6, *supra.*

[103]

For these purposes, a "Withholding Imposition Action shall be deemed to have occurred on September 13, 2010 with respect to any Transaction with respect to which withholding of a Dividend Equivalent Tax would be required after that date (which withholding is not otherwise required pursuant to an action taken by a taxing authority after September 13, 2010), and any change in the treatment of a Transaction under Section 871(m) that occurs on a specific date that is on or before March 18, 2012 by reason of inaction by the United States Treasury Department shall be treated as a Withholding Imposition Action." Protocol, Attachment, section 3.

[104]

Id.

[105]

Id.

[106]

A recording of this call is available at www.isda.org/isda2010hireactprot/docs/HIRE-ACT-Protocol-Market-Education-Call-August27th2010.mp3.

[107]

Protocol, Attachment, section 2.

[108]

Reporting and withholding on U.S. source FDAP income is a Tier 1 issue, and the "potential use of total return swaps to minimize withholding tax" has been identified as an issue of concern. See "LMSB Tier I Issue—U.S. Withholding Agents—§1441: Reporting and Withholding on U.S. Source FDAP Income," available at www.irs.gov/businesses/corporations/article/0,,id=205415,00.html. See also "Industry Directive on Total Return Swaps ('TRSs') Used to Avoid Dividend Withholding Tax," available at www.irs.gov/businesses/corporations/article/0,,id=218225,00.html.
[109]

Protocol, Attachment, section 2.
[110]

Id.
[111]

Id.
[112]

As drafted, this representation is considered to be made by a party that "has made a payee representation that is substantially equivalent to the representations in clause (iv), (v), or (vi) of Part 2(b) of the Schedule to the 2002 ISDA Master Agreement." These references are to the "non-U.S. branch of a foreign person" and the "foreign person" representations discussed in the text, above. As already noted, parties often neither require nor provide any payee tax representations in "foreign to foreign" transactions. If a party wants its counterparty to make this new HIRE Act representation, however, it must insist on the counterparty making a "non-U.S. branch of a foreign person" or a "foreign person" representation (or the substantial equivalent thereof).
[113]

Protocol, Attachment, section 8(a). See note 39, *supra* (noting that foreign hedge funds and foreign swaps dealers will qualify as "foreign financial institutions"). See also "Memo on HIRE Act Protocol," available at www.isda.org/isda2010hireactprot/docs/2010hireactprot-Summary-Memo.pdf ("This provision in the Protocol ensures that it is always the payee's responsibility for the US withholding tax under these new FATCA provisions, given it is within the payee's control as to whether they decide to comply with the new FATCA reporting requirements. We realize that some parties are concerned about making representations regarding these FATCA reporting provisions when it is still unclear what will be required to comply with these provisions. However, there are transactions being entered into now that will have payments occurring after December 31, 2012. Therefore it is important to clarify now that the payee has responsibility for any withholding taxes that could arise").
[114]

A Foreign Fund should not have to disclose the identity of any of its third-party investors in connection with entering into such an agreement. In general, a foreign financial institution entering into such an agreement must disclose the identities of holders of "U.S. accounts" that are "specified United States persons" or "substantial United States owners" of "United States owned foreign entities." See Sections 1471(b)(1)(C) and 1471(c)(1)(A). If the Foreign Fund entering into the agreement is a master fund, it will be required to disclose the identity of the U.S. feeder fund, which would be a "specified United States person." The master fund would not be required to disclose the identities of the partners in the U.S. feeder fund. In addition, the offshore feeder fund would likely not have any "substantial United States owners," as the U.S. tax-exempt investors in the offshore feeder fund are excluded from the definition of "specified United States person," and therefore from the definition of "substantial United States owner." See Sections 1473(2) and 1473(3)(C). If the Foreign Fund entering into the agreement is a stand-alone parallel fund, it would not have to identify its U.S. tax-exempt investors (as they are excluded from the definition of "specified United States persons") or its foreign investors (unless they were "United States owned foreign entities").
[115]

This clause appears problematic. If "the Transaction provides for one or more amounts that are treated as a 'dividend equivalent' as defined in Section 871(m)" (as the Protocol provides), then the swap is by definition a "specified notional principal contract" (because in the swap context, Section 871(m)(2)(B) defines a "dividend equivalent" as "any payment made *pursuant to a specified notional principal contract* that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States" (emphasis added)), such "dividend equivalent" will be subject to withholding tax and the representation is irrelevant and meaningless. The purpose of the representation is to attain comfort that the swap is not a "specified notional principal contract" by reason of certain actions by the long party, and that payments under the swap are therefore not "dividend equivalents" potentially subject to withholding. Presumably, the provision was intended to apply, and short parties should consider modifying the provision in the Schedule to apply, to a transaction if "the Transaction provides for one or more amounts that *would otherwise* be treated as a 'dividend equivalent' as defined in Section 871(m) *if the Transaction were a 'specified notional principal contract.'*"
116

The Protocol states that this representation is made by the long party if such party "has not represented that for United States federal income tax purposes either (1) it is a 'U.S. person' (as that term is used in section 1.1441-4(a)(3)(ii) of United States Treasury Regulations) for United States federal income tax purposes or (2) [it] is not a 'U.S. person' (as that term is used in section 1.1441-4(a)(3)(ii) of United States Treasury Regulations) and its income with respect to the Transaction is effectively connected with a trade or business in the United States." Often, a U.S. party does not represent that it is a "U.S. person," but instead represents something along the following lines: "it is organized under the laws of state x and its taxpayer identification number is y." However, to prevent the cross in/cross out representation (which is deemed made by a party that has not represented that it is a "U.S. person" or is not a "U.S. person" with respect to which the swap income from the transaction is ECI) from applying, U.S. parties would be well advised to instead make the "U.S. person" representation.
117

Protocol, Attachment, section 8(b). It appears that the word "it" is missing between the "(2)" and the "is" at the end of the fourth line of this section.
118

Id.
119

It was noted on the HIRE Act Protocol Market Education Call that the "in connection with" language highlighted in the text is intended to address the fact that the long party may have multiple trading desks, and that a particular trading desk may trade the underlying equity in a transaction unrelated to the swap transaction. The "in connection with" language, which is the language used in Section 871(m), clarifies that there was no MOC/MOO trading in connection with the swap, but leaves open the possibility that another trading desk of the long party entered into MOC/MOO transactions that were not related to the swap.
120

The Protocol also amends the payee representations by providing that if a party has made a treaty representation, then that representation will apply also to any "Dividends" provision of the specified treaty. Because Foreign Funds are typically organized in tax haven jurisdictions, treaty representations are not typically made in Schedules documenting swaps with Foreign Funds.
121

Protocol, Attachment, section 6. It appears that the word "of" is missing between the "addition" and the "the" on the second line of this section.
122

See User's Guide, *supra* note 58, pages 43-44, fn. 7.
123

Protocol, Attachment, section 9.

[124] *Id.*