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HIRE Act Imposes New U.S. Withholding Tax Requirement on Payments of Synthetic Dividends under Equity Swap, Security Lending, and Repo Contracts

On March 18, 2010, President Obama signed into law H.R. 2847, the Hiring Incentives to Restore Employment Act (HIRE). HIRE changes current U.S. law to require withholding tax on "dividend equivalent" payments made under equity swap contracts, much like what is currently provided for securities loans and repo agreements by regulation (which now will be codified). For certain "specified" equity swap contracts, as well as security lending and repo agreements, this change is effective for payments made on or after September 14, 2010 (180 days after HIRE's enactment). For all other swap contracts, this change is effective for payments made on or after March 18, 2012 (2 years after HIRE's enactment).

HIRE's withholding tax provisions may materially alter payment amounts and withholding obligations under existing longer-term swap contracts, and may trigger change-in-law provisions under such contracts. Thus, a foreign party to an affected swap might receive a payment reduced by the new withholding tax. Alternatively, a U.S. party to an affected swap might be required to "gross-up" for the withheld tax, depending on the terms of the swap contract. Clients with, or planning, longer-term equity swaps should evaluate these new rules closely.

HIRE also incorporates a number of other provisions designed to crack down on perceived offshore tax avoidance by U.S. persons. Please see Ropes & Gray's Alert, for more information on these other provisions.

Withholding Tax on Swap Payments before HIRE

Payments of interest, dividends, and other types of fixed or determinable periodic income made from a U.S. source to foreign persons are generally subject to U.S. withholding tax at a 30% rate, unless an exemption from withholding or a reduced withholding rate applies (for instance, under a tax treaty). Dividends paid by U.S. corporations generally qualify as U.S.-source payments. Tax treaties may sometimes reduce withholding on dividends, but are only available to eligible parties in certain jurisdictions, and generally do not eliminate withholding completely.

In contrast, payments under a swap contract typically have qualified as payments under a "notional principal contract" for withholding tax purposes, and have been sourced at the residence of the payee. As a result, payments to a foreign person under a notional principal contract that references a U.S. corporation's stock have traditionally been treated as foreign-source for U.S. withholding tax purposes and have been exempt entirely from U.S. withholding tax.

"Dividend Equivalent" Swap Payments under HIRE

Adopting provisions from the Foreign Account Tax Compliance Act of 2009 (H.R. 3933, S. 1934) introduced in late 2009 (which was never enacted), HIRE treats "dividend equivalent" payments under certain notional principal contracts as dividends from U.S. sources and therefore subject to the U.S. withholding tax rules.

Under HIRE, a "dividend equivalent" payment is a payment made pursuant to a *specified* notional principal contract that is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States. For the first two years following HIRE's enactment, a notional principal contract is a *specified* notional principal contract only if it possesses one or more of the following characteristics:

i. any long party to the contract transfers the underlying security to any short party to the contract in connection with entering the contract;

ii. any short party to the contract transfers the underlying security to any long party to the contract at the termination of the contract;

iii. the underlying security is not readily tradable on an established securities market;

iv. any short party to the contract posts the underlying security as collateral with any long party to the contract; or

v. the contract is identified by the Secretary as a specified notional principal contract.

Beginning two years after the date of the enactment of HIRE, "dividend equivalent" payments made pursuant to all other notional principal contracts will be treated as specified notional principal contract payments and will therefore become subject to the new withholding tax rules. Payments made with reference to an index or basket of U.S. source securities will be equally subject to the provisions applicable for "dividend equivalents" relating to a single security. In addition, when a payment is subject to the new rules, withholding tax will apply to the gross payment amount the parties use to calculate any net payment actually made.

HIRE grants the U.S. Treasury authority to exempt from the new withholding tax rules any contracts that do not have the potential for tax avoidance, but also to expand the definition of "dividend equivalent" to include any payment substantially similar to the payments identified in the statute. HIRE's legislative history refers specifically to payments under total return swaps as an example of the payments to which the provision "generally applies."

"Substitute Dividends" under HIRE

HIRE also codifies the treatment of "dividend equivalent" payments as "substitute dividends" when made pursuant to a securities lending or a sale-repurchase agreement that is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States. Previous IRS guidance had indicated that the withholding tax on such payments may be reduced when the payer would itself be subject to withholding tax on the relevant dividend; however, HIRE appears to eliminate such withholding tax reduction for substitute dividends made on or after September 14, 2010, at least until the IRS issues further guidance.

Consequences of HIRE under Standard ISDA Swap Terms

For certain "specified" swaps, the new withholding tax rules will apply for dividend equivalent payments made on or after September 14, 2010. For all other equity swap contracts described above, the new rules apply to payments made on or after March 18, 2012. As a result, HIRE's changes in the withholding tax law could affect long-term swap contracts that are in place currently or will be entered into after March 18, 2010.

Due to the expanded withholding tax obligation on the payer, a party to an affected swap may receive a reduced net amount. In some cases, a swap contract may require the payer to "gross-up" a payment so that the net amount would be the same as it would have been if no withholding had applied. However, swap contract terms often provide relief from the gross-up if there has been a change in tax law since the trade date of the contract. HIRE will presumably constitute an applicable change in tax law under any such existing agreement. For swaps entered after March 18, 2010, the new withholding tax rules are unlikely to constitute a "change in tax law" as defined by the swap contract, because HIRE was adopted prior to the trade date for any such transaction.

In order for the change in tax law provisions of a standard swap contract to apply, the party whose obligations or rights are affected generally must provide notice to the counterparty of the change in tax law, and must use reasonable efforts to transfer the relevant transactions to another office or affiliate so as to avoid the new tax liability. The affected party typically may terminate the transaction upon further notice if the contract cannot be transferred.

Clients that may face increased withholding obligations or reduced payment rights under the new "dividend equivalent" rules, or that are considering entering swap agreements for which the new rules will eventually apply, are encouraged to contact the Ropes & Gray attorney who normally advises them for further information.

CIRCULAR 230 DISCLOSURE

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