US
Morrison & Foerster

Isda 2010 Hire Act Protocols

As discussed in more detail in a prior column, the Hiring Incentives to Restore Employment Act (Hire Act), which was enacted in March of this year, treats as a US-source dividend any dividend equivalent for purposes of US withholding tax provisions. The effect of this provision, which applies to payments after September 14 2010, is to impose a 30% withholding tax on such payments unless reduced by treaty.

A dividend equivalent is (i) any substitute dividend (made pursuant to a securities-lending or repo transaction), (ii) any amount paid pursuant to a specified notional principal contract, and that is contingent on, or determined by reference to, the payment of a US-source dividend, and (iii) any amount that the Treasury determines is substantially similar to a payment described in (i) and (ii).

A specified notional principal contract may include an equity swap and as a result a dividend equivalent may include payments under a cross-border equity swap that are determined by reference to a dividend distribution on a US equity security.

To address these Hire Act consequences, in August of this year the International Swaps and Derivatives Association (Isda) released a protocol (the Original Protocol) amending its standard equity swaps documentation.

The Original Protocol includes the following changes:

(i) the party to an equity swap that is required to withhold US tax on a dividend equivalent will not be required to pay a gross-up;

(ii) the addition of representations by the payee (eg representations to ensure that the equity swap should not be considered a specified notional principal contract and representations that the payee will meet the information sharing requirements to avoid the new 30% Fatca withholding tax on withholdable payments); and

(iii) the addition of certain termination rights (eg in the event there is a substantial likelihood the US payor would otherwise be required to pay a gross-up on the next scheduled payment date, or the IRS provides written notice of an intention to assess tax in connection with an equity swap).

Following release of the Original Protocol, foreign counterparties have resisted these provisions. As a result, including or not including all or some of the provisions included in the Original Protocol was the subject of case-by-case negotiation.

To address the concerns raised following the release of the Original Protocol, in November of this year Isda released a second protocol (Short Form Protocol), deleting the representation related to the new 30% Fatca withholding tax and the additional termination rights. Further, the Short Form Protocol includes provisions addressing transactions in which one of the non-US parties is a dealer in derivatives.

If the parties to a swap have adhered to both the Original Protocol and the Short Form Protocol, the terms of the Short Form Protocol provide that it will supersede in all respects the Original Protocol. More information on the protocols including a list of adhering parties can be found on Isda's website.

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