

September 1, 2010

## ISDA Protocol Addresses New Withholding Rules for Dividend Equivalent Payments

On August 23, 2010, the International Swaps and Derivatives Association (ISDA) announced a new Protocol intended to address new U.S. withholding tax rules for certain notional principal contract payments. Under the new U.S. withholding tax rules, which were enacted in March as part of the Hiring Incentives to Restore Employment Act (HIRE Act), a payment made pursuant to a “specified notional principal contract” that is contingent upon, determined by reference to, or made in substitution of a U.S. source dividend payment (a “dividend equivalent payment”) generally will be treated as a dividend from U.S. sources for U.S. tax purposes. U.S. source dividends generally are subject to withholding tax at a 30% rate, except where the rate is reduced by an applicable treaty. As a result, U.S. withholding tax generally will be imposed at a 30% rate on the gross amount of a dividend equivalent payment, unless the applicable withholding rate is reduced under the terms of an income tax treaty.

Specified notional principal contracts that currently are covered by the new provision include notional principal contracts where a party transfers the underlying security to the other party (including as collateral) and contracts with respect to securities that are not readily traded on an established market. After March 18, 2012, this definition is expanded to include *all* notional principal contracts except those specifically identified by the IRS as not having the potential for tax avoidance. Thus, a significant number of notional principal contracts may be impacted by the new rules.

The Protocol is intended to assist parties in modifying their notional principal contracts to take into account the new withholding rules with respect to dividend equivalent payments. Parties to ISDA Master Agreements may elect to adhere to the Protocol by filing a statement with ISDA. Generally, an ISDA Master Agreement between two parties that have elected adherence to the Protocol is considered to be amended to include the terms of the Protocol as of the first date on which both parties have elected adherence to the Protocol. The material changes to the ISDA Master Agreement effected by adherence to the Protocol are summarized below.

- The Section 2(d)(ii) gross-up provisions are modified to take into account that the HIRE Act imposes withholding on a gross basis, even though notional principal contracts typically provide for net payments, which may be less than the amount of the withholding due. If the amount of the net payment to be made by one party (X) to the other party (Y) is less than the amount withholding tax imposed on the payment, then the Protocol provides that X will pay to Y the amount of such shortfall.
- The Tax Event provisions are modified to provide that assessments and notices of assessment issued by the IRS with respect to “substantially similar” transactions may give rise to a Tax Event.
- Special rules are included regarding the termination of transactions as a result of the imposition of a tax with respect to a dividend equivalent payment as a result of a change in tax law after the date of the transaction, including as a result of the enactment of the HIRE Act.
- The definition of “Indemnifiable Tax” is modified to exclude a tax imposed by the HIRE Act on a dividend equivalent payment (as well as taxes imposed under the foreign account compliance provisions of the HIRE Act).

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- The Payer Representations are modified to exclude dividend equivalent taxes (and taxes imposed under the foreign account compliance provisions of the HIRE Act) from the representation that no tax is required to be withheld on payments made by the Payer.
- If the Payee Representation includes a treaty representation, it is deemed to be modified to include an equivalent representation as to eligibility for the benefits of the dividend provision of the relevant treaty. In addition, the Payee Representations are modified to ensure that a notional principal contract is not a “specified notional principal contract” prior to the general effective date of March 2012. Certain modifications also are made to account for the foreign account compliance provisions of the HIRE Act.
- Consistent changes are made to the requirement to provide tax forms.

Parties to equity derivatives transactions should carefully consider the application of the HIRE Act provisions to their current and future transactions, and may wish to consider adherence to the Protocol. ISDA has indicated that the Protocol is open for adherence by both ISDA members and non-members. Partial adherence to the Protocol is not permitted. Thus, parties should carefully consider the implications of adherence to the Protocol to ensure that adherence achieves the desired results. In some cases, it may be preferable to adopt portions of the Protocol through separate negotiations with counterparties.



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