

MEMORANDUM

TO: Members of International Swaps and Derivatives Association
RE: New Tax Withholding and Reporting Rules for Swaps
DATE: February 4, 1998

On October 6, 1997, the Internal Revenue Service issued final regulations that include rules on withholding and information reporting for swap payments. These new rules are effective for payments made on or after January 1, 1999. Thus, the new rules should be taken into account in negotiating and documenting any swap that provides for payments to be made on or after January 1, 1999, regardless of when the swap is entered into.

The purpose of this memorandum is to provide a summary of the provisions in the new regulations that will be most important to marketing, operations and compliance personnel responsible for negotiating and documenting swaps. This memorandum does not include legal citations and is not intended to be a technical legal discussion of the new regulations. It is intended only to be a general summary, and it does not discuss all provisions of the new rules that may be relevant to all kinds of swaps and counterparties. Thus, internal counsel and/or outside counsel should be consulted to ensure that documentation for particular transactions, and information reporting and withholding policies, comply with the new regulations.

Although the new regulations include withholding and reporting rules for payments other than swap payments, such as interest and dividends, the discussion in this memorandum is limited to the rules for swap payments.

I. Swaps with Foreign Counterparties

A. Information Reporting

Under the new rules, information reporting is required for swap payments made to a foreign counterparty if they are effectively connected with the conduct of a trade or business in the U.S. Reporting is required to be made on Form 1042-S. However, swap payments made to a foreign counterparty that are not effectively connected with the conduct of a trade or business in the U.S. are not reportable on Form 1042-S if the foreign counterparty provides the appropriate documentation.

1. Presumption That Payments Are Effectively Connected

The new rules provide that all swap payments to a foreign person must be treated as effectively connected with a U.S. trade or business, and thus must be reported on

Form 1042-S, unless certain conditions are met. These conditions differ, depending on whether the counterparty is a financial institution.¹

a. Foreign Counterparties That Are Not Financial Institutions

If the foreign counterparty is not a financial institution, the payor must be able reliably to associate the payment with a withholding certificate upon which it can rely to treat the payment as an amount that is not effectively connected with the conduct of a U.S. trade or business of the foreign counterparty. Thus, if a U.S. person enters into a swap with a foreign counterparty that is not a financial institution, such as a manufacturing corporation, it will be required either to obtain a withholding certificate from the foreign counterparty or to report payments under the swap on Form 1042-S as income that is effectively connected with the conduct of a trade or business in the U.S.

b. Foreign Counterparties That Are Financial Institutions

If the foreign counterparty is a financial institution, either (a) the payor must obtain a withholding certificate (as described in the preceding paragraph), or (b) the counterparty must represent in a master agreement that governs swap transactions between the parties, such as the ISDA Agreement (including the Schedule), or in the confirmation for a particular transaction, that the counterparty is a U.S. person or a non-U.S. branch of a foreign person. These representations are not required to be made under penalties of perjury.

The regulations do not expressly address the situation in which the master agreement between the parties is a multibranch master agreement that permits the foreign counterparty to enter into notional principal contracts either through an office in the U.S. or through an office outside the U.S. We believe that, in this case, a master agreement entered into by a foreign counterparty could include a representation that if the party to the confirmation for a particular transaction is an office of the counterparty outside the U.S., the counterparty to that transaction is a non-U.S. branch of a foreign person.

ISDA is currently working to revise the Master Agreement to include these representations.

¹ For purposes of the rule dealing with Form 1042-S information reporting on swap payments, a "financial institution" is defined as a person that is, or more than 50 percent of the total combined voting power of all classes of whose voting stock is owned by a person that is, (a) engaged in a banking, financing or similar business, (b) engaged in business as a broker or dealer in securities, (c) an insurance company, (d) a provider of pensions or similar benefits to retired employees, (e) primarily engaged in the business of rendering investment advice, (f) a regulated investment company or other mutual fund or (g) a finance corporation. However, for other purposes under the new withholding rules, the definition of "financial institution" is narrower, and excludes persons described in (d) and (f). See, for example, the agency rule described below in paragraph I.A.2.c ("Counterparties That May Be Agents for Foreign Principals").

2. Special Rules for Certain Types of Counterparties

a. Counterparties That Are U.S. Partnerships with Foreign Partners

Swap payments to a counterparty that is a U.S. partnership are treated as payments to a U.S. person even though the partnership may have partners that are foreign persons.

b. Counterparties That Are U.S. Trusts with Foreign Beneficiaries

It is not clear how the Form 1042-S reporting rules will apply to a swap with a counterparty that is a U.S. trust with foreign beneficiaries (or, in the case of an investment trust, foreign certificate holders). The new regulations expressly reserve as to the rules that apply to payments to trusts and estates.

The proper treatment of payments to and by trusts is an issue for parties to "swap trust" transactions. In these transactions, a U.S. trust holding debt securities (or other assets) enters into a swap and sells certificates to investors that may include foreigners. In the absence of guidance from the Internal Revenue Service as to how the reporting rules will apply to these transactions, it would be advisable to require foreign certificate holders to provide withholding certificates representing that income derived from the trust will not be effectively connected with the conduct of a U.S. trade or business.

ISDA is seeking clarification as to how the reporting rules will apply (a) to swap payments to a swap trust that has foreign certificate holders and (b) to distributions by such a trust of amounts that are attributable to swap payments to the trust.

c. Counterparties That May Be Agents for Foreign Principals

For purposes of Form 1042-S reporting, if the swap counterparty is a U.S. person, other than a "financial institution" (defined to exclude providers of pension benefits, regulated investment companies and other mutual funds), who may be acting as an agent for a foreign person, payments are treated as made to a U.S. person provided that the payor does not have actual knowledge that the swap counterparty is acting as an agent of a foreign person.

However, if the swap counterparty is a U.S. financial institution (which would generally include an investment advisor), the payments are generally treated as made to a U.S. person even if the payor has actual knowledge that the swap counterparty is acting as an agent of a foreign person.

3. Other Special Rules Applicable to Information Reporting

a. Reporting of Embedded Interest on Form 1042-S

If a swap provides for a yield adjustment fee to be paid by a foreign counterparty that is treated as a "significant" nonperiodic payment, the swap will be treated

as including a loan by the foreign counterparty. In this case, a portion of the swap payments to the foreign counterparty will be treated as interest for United States federal income tax purposes. Such embedded interest is required to be reported as interest on Form 1042-S even if such interest is not effectively connected income.

b. Exemption from Form 1099 Reporting for Payments to Foreign Counterparties

Payments to a foreign counterparty are not subject to the Form 1099 information reporting rules described below (which apply to swap payments to certain U.S. counterparties) provided that the foreign counterparty has properly documented its foreign status. It may do this by a representation that it is a foreign person contained in a master agreement that governs the transactions in notional principal contracts between the parties (such as the ISDA Agreement, including the Schedule) or in the confirmation for the particular swap transaction. Alternatively, the counterparty may certify its foreign status on Form W-8.

It is important to note that this representation as to foreign status may be made in the ISDA Agreement by any foreign counterparty, and not—as is the case for the representation for purposes of determining whether swap payments are "effectively connected" income—only by a foreign financial institution.

c. Single Form W-8 for Related Withholding Agents

The regulations provide that, in certain circumstances, a withholding agent that is a financial institution will not be required to obtain a Form W-8 from a foreign counterparty if a related withholding agent already holds an effective Form W-8 for that foreign counterparty. For example, the withholding agent may rely on a Form W-8 furnished for another account of the foreign counterparty at the same branch location, or, provided the group uses a universal account system or other coordinated account system that satisfies specified criteria, at a different branch location of either the same withholding agent or a related person.

B. Withholding

1. General Rule

The new rules provide that no withholding is required on amounts paid under the terms of a swap regardless of whether a withholding certificate has been provided. This general rule applies to payments under interest rate, currency, commodity and equity swaps, caps, floors and collars, subject to certain exceptions described below.

Under current law, a foreign counterparty that enters into a swap through a U.S. branch must provide a Form 4224 in order to avoid U.S. withholding tax. When the new regulations take effect, it will not be necessary to obtain a Form 4224 to avoid withholding in this case. As explained above, however, it will be necessary to report such payments on Form 1042-S.

2. Potential Exceptions

a. Swaps with Embedded Loans

If a swap with a foreign counterparty is off-market and provides for a "significant" nonperiodic payment by the foreign counterparty, the swap may be characterized for tax purposes as including a loan from the foreign counterparty. Thus, a portion of the swap payments to the foreign counterparty may be treated as interest for U.S. withholding tax purposes. Such amounts are subject to the same withholding tax rules that apply to interest.

Under these rules, no withholding would be required if the foreign counterparty is eligible for the benefits of a tax treaty (for example, the treaty between the U.S. and the United Kingdom) that exempts payments of interest from U.S. tax, and the swap counterparty has provided the documentation required to claim the benefits of the treaty. In addition, no withholding would be required if the interest on the embedded loan meets the requirements of the "portfolio interest" exemption (which include, among other requirements, furnishing a Form W-8).

b. Equity Swaps

Although the new rules do not require withholding on payments to foreign counterparties under equity swaps, proposed regulations are expected to be issued in the near future that will provide rules dealing specifically with withholding on equity swap payments. Although we do not know the content of those regulations, it is possible that the regulations will require withholding on amounts equivalent to dividends paid under equity swaps.

II. Swaps with U.S. Counterparties

A. Information Reporting on Payments to U.S. Persons That Are Not "Exempt Recipients"

Under the new rules, information reporting on Form 1099 is required for swap payments to a U.S. counterparty that is not a corporation or other "exempt recipient".

1. Who is an "Exempt Recipient"?

An "exempt recipient" includes, among others, (a) a corporation (including certain partnerships all of whose members are corporations), (b) a pension plan, charity, university or other tax-exempt organization, (c) a bank or other financial institution, (d) a registered dealer in securities, commodities or notional principal contracts, (e) a broker, (f) the U.S. government or a state or local government and (g) a foreign government or international organization.

The new rules provide an "eyeball test" under which a payee may be presumed to be a corporation if its name includes an unambiguous expression of corporate status--

Incorporated, Inc., Corporation, Corp., P.C., (but not Company or Co.)--or contains the term insurance company, indemnity company, reinsurance company, or assurance company.

Under another "eyeball test", a payee may be presumed to be a bank or other financial institution (and thus an exempt recipient) if its name (including a foreign name such as "Banco" or "Banque") reasonably so indicates.

2. Exemption for Certain Payments Made Outside the U.S. by Foreign Payors

In some cases, swap payments made outside the U.S. are exempt from information reporting on Form 1099, even if the counterparty is not an "exempt recipient". Whether this exemption is available depends on the identity of the payor. For purposes of determining availability of the exemption, payors can be divided into three categories.

The first category includes all U.S. persons other than the foreign branches of U.S. banks. For this purpose, U.S. persons include, among others, corporations and partnerships formed under the laws of the U.S. The exemption from Form 1099 reporting for payments made outside the U.S. is not available for payments by payors in this category.

The second category includes foreign branches of U.S. banks and foreign persons that are related in certain specified ways to a U.S. person--for example, a controlled foreign corporation and a foreign partnership that is more than 50-percent owned by U.S. persons. This second category also includes foreign persons that are not related to U.S. persons, but which have other specified connections to the U.S. Such foreign persons include a U.S. branch of a foreign bank or foreign insurance company, a foreign partnership that is engaged in a U.S. trade or business at any time during the tax year and a foreign person 50 percent or more of the gross income of which, from all sources for the three-year period ending with the close of its tax year preceding the collection or payment, was effectively connected with the conduct of a U.S. trade or business. The exemption from Form 1099 reporting for payments outside the U.S. applies to payors in this category, but only if the payor does not have actual knowledge that the payee is a U.S. person.

The third category includes all foreign persons that are not in the second category. The exemption from Form 1099 reporting for payments outside the U.S. applies to payors in this third category, regardless of whether the payor has actual knowledge as to the payee's identity.

The new regulations provide rules for determining whether a payment is paid outside the U.S. Under these rules, a payment is considered to be paid outside the U.S. if the payor completes the acts necessary to effect payment outside the U.S. However, a payment is not considered to be made within the U.S. merely because it is made by a draft drawn on a U.S. bank account or by a wire or other electronic transfer from a U.S. bank account. Thus, for example, a dollar payment by the home office of a European bank is not considered to be made within the U.S. merely because it is by means of a check drawn on a New York bank account.

3. Form 1099 Reporting Required for Payments Made Within the United States

In the case of a payment made within the United States, Form 1099 reporting may be required, regardless of the identity of the payor. Thus, foreign persons in the second and third categories described above that make payments within the U.S. are potentially subject to Form 1099 reporting obligations.

B. Backup Withholding

The final regulations confirm that backup withholding at a rate of 31 percent applies to swap payments that are subject to information reporting on Form 1099 unless the counterparty properly provides its taxpayer identification number ("TIN") (which may, but need not be, provided on Form W-9) and certain other requirements are met.

It is important to note that the final regulations provide that all swap payments--including the interest components of payments on a swap treated as including an embedded loan--are subject to the information reporting and backup reporting rules that govern "fixed and determinable periodic income" rather than the rules that govern interest payments. Thus, the conditions for avoiding backup withholding are fewer than the conditions for avoiding backup withholding for interest and dividends. Nevertheless, based on the current versions of these forms, the interest component apparently should be reported on Form 1099-INT rather than Form 1099-MISC.

If a swap counterparty has an account or other relationship with the corporate entity that is the payor under which the swap counterparty receives interest or dividend payments, the requirements for avoiding backup withholding may have been met in establishing that account or relationship. Regulations that were adopted in December 1995, not discussed in this memorandum, provide rules for reliance in certain circumstances on a Form W-9 previously furnished by a customer in opening another account with the same payor.

C. Determining Identity of Counterparty

For purposes of Form 1099 information reporting (and thus for purposes of backup withholding), the person to whom payment is made is treated as the payee, regardless of whether the payee is acting as an agent for another person. In contrast to the rule for Form 1042-S information reporting, this rule applies regardless of whether the payor has actual knowledge that the payee is acting as an agent.

III. Computation of Amount of Swap Payments Subject to Reporting

A. Reporting of Nonperiodic Swap Payments When They Are Made, Not When They Are Taken into Account

The new rules provide that the information reporting requirements (including both Form 1042-S reporting and Form 1099 reporting) apply to nonperiodic swap payments

(such as yield adjustment fees) at the time the payments are made rather than at the time that they are taken into account for tax purposes. Thus, an up-front payment to a foreign counterparty on an off-market swap is subject to reporting in the year in which it is made, rather than as it is taken into account over the term of the swap. The rule providing that nonperiodic payments are reportable for the year in which payment is made does not expressly distinguish between a "significant" nonperiodic payment treated as a loan for federal income tax purposes, and other nonperiodic payments, and the intended application of this rule to significant nonperiodic payments is not clear.

B. Reporting of Net Amount of Swap Income, Not of Gross Amount of Payments

The new rules provide that information reporting (including both Form 1042-S reporting and Form 1099 reporting) is required only on the net amount of swap income taken into account. The new rule netting swap income for purposes of information reporting cross-refers to the regulations that govern determination of the amount of swap income taken into account for purposes of computing taxable income; these regulations effectively require use of an accrual method and net all payments taken into account for a taxable year on a particular swap. Accordingly, read literally, the new netting rule appears to place taxpayers on an accrual method for purposes of determining the amount of swap income subject to information reporting (and backup withholding), and to net all payments during a particular year, rather than only those made on a particular date. It is not clear whether the new rule was intended to have this effect, and ISDA is seeking clarification of the operation of the netting rule.

The netting rule only permits netting within a particular swap and does not permit netting of payments under different swaps, even though they involve the same two parties.