

MEMORANDUM

New US Tax Representations for Schedule to ISDA Master Agreement

Payments attributable to "notional principal contracts" generally are not subject to US withholding tax,¹ but may be subject to US information reporting and backup withholding. This memorandum summarizes legal background for sample representations that ISDA has provided for inclusion in the Schedule to the Multicurrency Master in order to qualify payments for exemptions. The general "no withholding" rule does not apply to payments treated as interest for US tax purposes, even though paid in a transaction documented as a swap.² This memorandum also discusses treatment of certain swap payments as interest and outlines possible exemptions from withholding.

1. Information Reporting

a. IRS Form 1042-S Reporting

Notional principal contract payments generally must be reported on IRS Form 1042-S if treated under IRS regulations as effectively connected with the conduct of a trade or business in the United States.³ A safe harbor provides, however, that payments need not be reported if the payee represents in the Schedule to the Multicurrency Master that it is a US person or a non-US branch of a foreign person.⁴

ISDA has provided sample alternative payee representations for this purpose that may be added in Part 2(b)(iv) of the Schedule: paragraph (A) (for US persons); paragraph (B) (for foreign persons that cannot act through a US branch); and paragraph (C) (for foreign persons that are multibranch parties able to act through a US branch). Before making the representation in paragraph (C), payees should carefully consider whether they will in fact be acting through a non-US branch in all transactions in which payments are to be made to an address or an account outside the United States. For example, a payee that directs payments to an account or address outside the United States with respect to all its transactions - including those in which it is acting through its US branch - could not make this representation.

¹ See Treas. Reg. § 1.1441-4(a)(3)(i). "Notional principal contracts" are defined by reference to Treas. Reg. § 1.863-7(a) and Treas. Reg. § 1.988-2(e) and include, for example, common interest rate and foreign currency swaps.

² See Treas. Reg. § 1.1441-4(a)(3)(i).

³ See *id.*

⁴ See Treas. Reg. § 1.1441-4(a)(3)(ii).

b. IRS Form 1099 Reporting

Notional principal contract payments must be reported to the IRS on Form 1099 unless the payee is a corporation or otherwise eligible for an exemption.⁵ IRS rules set forth indicia of corporate status on which a payer generally may rely to avoid reporting, including a Form W-9 with an employer identification number and a statement that the payee is a domestic corporation.⁶ Payments also need not be reported if the payee represents that it is a foreign person in the Schedule to the Multicurrency Master.⁷ Thus, foreign payees providing the new representations in paragraphs (B) and (C) to avoid Form 1042-S reporting also will be exempt from Form 1099 reporting. Other foreign payees may make the sample representation in paragraph (D) to avoid Form 1099 reporting.

A swap payment that is not exempt from Form 1099 reporting is subject to a backup withholding tax unless the payee provides a valid IRS taxpayer identification number.⁸

c. Payments to Foreign Partnerships and Trusts

The sample representations in the Schedule may be used by a foreign partnership or trust that qualifies as a "withholding foreign partnership" or "withholding foreign trust" (as evidenced by an IRS Form W-8IMY certifying to its status).⁹ Persons making payments to nonwithholding foreign partnerships and trusts should consult tax counsel as to the representations and forms needed to avoid information reporting and backup withholding.

2. Treatment of Payments as Interest

Swap agreements providing for up-front yield adjustment or other nonperiodic payments from a non-US party to a US party may be treated by the IRS as loans to the US person if those payments are "significant".¹⁰ If so, a portion of the payments *from* the US *to* the

⁵ See Treas. Reg. § 1.6041-1(d)(5). This rule generally does not apply to payments made outside the United States by payers other than US persons, US-controlled entities and persons engaged in US trades or businesses. Treas. Reg. §§ 1.6041-4(a)(2), 1.6049-5(c)(5).

⁶ See Treas. Reg. §§ 1.6041-3(q), 1.6049-4(c)(1)(ii)(A).

⁷ See Treas. Reg. § 1.6041-4(a)(4).

⁸ See Treas. Reg. § 31.3406(a)-1(b).

⁹ For purposes of Form 1042-S and Form 1099 reporting, payments to a withholding foreign partnership or withholding foreign trust are treated as made to the partnership or trust rather than to its partners or beneficiaries. See Treas. Reg. § 1.1461-1(c)(ii) (for purposes of Form 1042-S reporting, withholding foreign partnerships and withholding foreign trusts are treated as recipients); Treas. Reg. § 1.6041-1(d)(5) (provisions of Treas. Reg. § 1.6049-5(d) apply for determining whether notional principal contract payment is made to foreign person and thus exempt from Form 1099 reporting); Treas. Reg. § 1.6049-5(d)(3)(i) (incorporating by reference rules of Treas. Reg. § 1.1441-5 for payments to partnerships and trusts); Treas. Reg. § 1.1441-5(c)(1)(ii) (payment to withholding foreign partnership treated as made to partnership rather than to partners); Treas. Reg. § 1.1441-5(e)(5)(v) (same rules for trust qualifying as withholding foreign trust).

¹⁰ See Treas. Reg. § 1.446-3(g)(4).

non-US party will be US-source interest potentially subject to a 30-percent withholding tax.¹¹

Because there is no bright-line test whether a payment is "significant", agreements with up-front (or other non-periodic) payments *to* a US party *from* a non-US party should be reviewed by tax counsel to determine whether they could be loans for US tax purposes.¹² If the only up-front payment is *by* a US party, however, no review is necessary because interest paid *to* a US person is not subject to withholding. IRS regulations permit reliance on a representation on IRS Form W-9 that a party is a US person.¹³

Even if swap payments to a non-US party are treated as interest, no withholding is required if (a) the interest is effectively connected with the conduct of a trade or business in the United States,¹⁴ (b) the interest qualifies as "portfolio interest"¹⁵ or (c) the payee qualifies for the benefits of a treaty providing a full exemption.¹⁶

a. Effectively Connected Income

US-source interest is effectively connected income exempt from withholding if, prior to payment, the foreign beneficial owner of the payment provides a valid IRS Form W-8ECI with which the payment reliably can be associated that includes both (i) the owner's taxpayer identifying number and (ii) a representation, under penalties of perjury, that the amounts for which the certificate is furnished are effectively connected with the conduct of a trade or business in the United States and are includable in the owner's gross income for the taxable year.¹⁷

If a US payer relies on the effectively connected exemption in not withholding on payments that are treated as interest, the payer may be required to report payments under the agreement on IRS Form 1042-S.

b. Portfolio Interest

To qualify for the portfolio interest exemption, the payee must certify on IRS Form W-8BEN that it is a foreign person and is the beneficial owner of the payment.¹⁸ The exemption is not available, however, unless the obligation on which the interest is paid is in registered form.¹⁹ Rules for determining whether an obligation is in registered form²⁰ do not expressly address swap agreements. Parties often take the position that an

¹¹ A non-US party that posts collateral may also be treated as receiving US-source interest (or other) income potentially subject to withholding.

¹² Treas. Reg. § 1.446-3(g)(6), *Examples 2-4*.

¹³ See Treas. Reg. § 1.1441-1(d)(4).

¹⁴ See Treas. Reg. § 1.1441-4(a)(1).

¹⁵ See Treas. Reg. §§ 1.871-14(a), 1.1441-1(b)(4).

¹⁶ See Treas. Reg. § 1.1441-6(a).

¹⁷ See Treas. Reg. § 1.1441-4(a)(2)(i).

¹⁸ See Treas. Reg. § 1.871-14(c)(2).

¹⁹ IRC § 881(c)(2)(B).

²⁰ Treas. Reg. § 1.871-14(c)(1)(i).

agreement is in registered form if the foreign party's rights to receive payments can be transferred only with notice to the payer.

The portfolio interest exemption is denied to (a) a bank receiving interest on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business²¹ and (b) a payee related to the payer in specified ways.²² Thus, US persons making swap payments potentially treated as interest may consider requesting a representation in the Schedule that the payee is neither a bank nor related to the payer. IRS rules do not expressly authorize reliance on such representations, and ISDA has not provided sample language.

Special rules not discussed here may limit availability of the portfolio interest exemption for payments to foreign entities treated for US tax purposes as conduits for extensions of credit by non-US banks or related payees.²³

c. Treaty Exemption

A payer may treat payments of US-source interest as qualifying for relief from withholding if, prior to payment, the payment can be reliably associated with a withholding certificate on IRS Form W-8BEN with all the representations and other information necessary to support the payee's claim of treaty benefits.²⁴

Not all tax treaties provide complete exemption from tax for US-source interest payments; some provide only a reduced rate. A payer must examine the provisions of the applicable treaty before determining that payments treated as interest for US tax purposes will be exempt from withholding.

Special rules²⁵ not discussed here apply in determining the availability of treaty benefits in the case of payments of US-source interest to foreign partnerships and other fiscally transparent entities.

²¹ IRC § 881(c)(3)(A).

²² IRC § 881(c)(3)(B), (C).

²³ Treas. Reg. §§ 1.881-3, 1.1441-3(g).

²⁴ See Treas. Reg. § 1.1441-6(b)(1).

²⁵ Treas. Reg. § 1.894-1.