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The Honorable Richard E. Neal
Chairman
House Ways and Means Select Revenue Measures Subcommittee
1102 Longworth House Office Building
Washington, D.C. 20515

The Honorable Patrick J. Tiberi
Ranking Member
House Ways and Means Select Revenue Measures Subcommittee
1102 Longworth House Office Building
Washington, D.C. 20515

Re: H.R. 3933 – Provisions on Equity Swap Withholding
Commentary and Proposals

Dear Chairman Neal and Ranking Member Tiberi:

ISDA's members appreciate the opportunity to comment on the provisions of section 501 of H.R. 3933 (the "Bill"), relating to the imposition of U.S. withholding tax with respect to certain payments made on equity swaps. The Bill also is referred to as the "Foreign Account Tax Compliance Act of 2009." This letter summarizes the salient aspects of current law, the provisions of the Bill and the views of ISDA's members on a number of technical and other aspects of the Bill.

Current Law

- In general, dividends paid with respect to the stock of a domestic corporation are U.S.-source dividends and thus are subject to a 30 percent U.S. withholding tax. This rate may be reduced where the dividends are paid to a resident of a jurisdiction with which the United States has entered into a tax treaty.

- The source of income from swaps is generally determined based on the residence of the payee. As a result, dividend-related payments made to a foreign investor with respect to an equity swap referencing U.S. equity securities are treated as foreign-source and are therefore not subject to U.S. withholding tax.

Summary of the Bill

- The Bill reflects the refinement of a proposal previously advanced by the Treasury Department (the "Greenbook Proposal"). The Bill follows the Greenbook Proposal in that it would impose a withholding tax on income earned by foreign persons on equity notional principal contracts

("equity swaps") that is contingent on (or calculated by reference to) dividends paid by a domestic corporation.

- The Bill accomplishes this by treating such income as U.S.-source dividend income.

- The Bill permits the Treasury Department issue regulations that would apply the Bill's withholding rules to financial contracts other than notional principal contracts that have dividend-related payments.

- The Bill provides the Treasury Department with authority to exclude from the new withholding rule swaps that it determines do "not have the potential for tax avoidance." The Bill indicates that in making that determination, the Treasury Department "may" take into account the following factors:

  1. the term of the swap (including provisions for terminations and offsetting financial contracts);

  2. the amount of each party's investment and the amounts of any collateral posted;

  3. whether the price of the equity used to measure the parties' entitlements or obligations is based on an objectively observable price;

  4. whether either party sells (directly or indirectly) to the other party the security giving rise to U.S.-source dividend income;

  5. whether there are terms that address the hedge position of either party or other conditions that would compel either party to hold or acquire the security giving rise to U.S.-source dividend income; and

  6. other factors that the Treasury Department considers appropriate.

The Bill provides that for purposes of determining amounts to be withheld, the amount of the dividend deemed to have been paid is based on the gross amount used in computing any actual payments made. The Bill also provides that all parties to an equity swap are treated as withholding agents liable for remitting the withholding tax imposed. The Bill's provisions would be effective for payments made 90 days after the date of enactment of the Bill. Thus, withholding would be required with respect to future payments made on swaps that are already in existence.

Commentary and Proposals

General commentary:

ISDA's members believe appropriate action should be taken to eliminate abusive dividend withholding tax avoidance transactions in the form of equity swap transactions. Accordingly, we appreciate the opportunity to provide Congress and the Treasury Department with input into the development of appropriate rules for the tax treatment of cross border equity swaps. We look forward to having a constructive dialog to assist in the development of workable rules that would eliminate abuses without hindering legitimate commercial transactions.

Perhaps our most significant concern with the Bill as currently drafted is that it would subject all equity swaps to withholding tax prior to promulgation of a regulatory safe harbor for non-tax-avoidance transactions. The clear intent of Congress is to target only those transactions having the potential for tax avoidance. Accordingly, it would be unfair and unduly disruptive to the markets to impose withholding for some interim period on transactions that regulations later declare do not have a tax-avoidance purpose. Moreover, if the statute becomes effective prior to the issuance of regulations, the imposition of a withholding tax will result almost uniformly in the dealer making the dividend related payment having to "gross up" for the withheld tax. The requirement placed on the dealer to make such gross-up payments is known as a "tax event," which with equal uniformity would permit the dealer to unilaterally terminate those swaps. In these circumstances, there would be enormous pressure on dealers and their counterparties to renegotiate a potentially overwhelming number of contracts in a short period of time to eliminate the gross-up obligation, failing which dealers would be compelled to terminate the contracts. The unwinding of a large number of swaps within a short period of time has considerable potential to create market disruptions and significant losses for market participants due to forced selling. The rapid unwinds of existing swaps that would take place with the Bill's current effective date, also raise complex issues concerning the need for appropriate transition relief, which we would like to discuss.

Implementation issues

Systems to implement any new statutory mandate for reporting and withholding require extensive development time, even for the seemingly simplest of functions. For example, the modification of systems to implement the withholding for dividends and interest required several years. The proposed rules for withholding on swaps will involve significantly more complex development and resulting time, effort and capital. The work required to develop any operational system is enormous, insofar as it must include the allocation of resources, the creation of a project plan, and coordination of several functions, including tax, operations, information technology, business areas, legal, finance, programming, and testing. Moreover, the system required to report and withhold on the "gross dividend" amount is unlike any withholding system currently in place, and would involve novel information technology that goes beyond anything currently developed. Further, the details of the regulations, when issued, will require a system of checks and balances to evaluate when and if certain criteria are met. This type of complex system simply will require significant time to develop and build.

Accordingly, ISDA's members are particularly concerned about a scenario in which the Bill becomes effective without a sufficient amount of time to adapt their operational systems *following* issuance of the regulations that would except non-tax-avoidance transactions from the Bill's provisions and otherwise make needed clarifications. Even if the regulatory safe harbors are in place when the provisions of the Bill become effective, without enough time to adapt their computer systems, dealers will be unable to comply and will have no choice but to elect to unwind their swaps with the potentially adverse consequences described above. Moreover, because of the inability of their systems to determine whether withholding is required and in what amounts, market participants would have no choice but to refrain for an indefinite period from entering into any sort of equity swap transactions, even those that clearly would be considered to have no tax avoidance purpose.

It also should be understood that because of the high stakes involved in acting as withholding agent, certainty about application of the rules will be crucial. To provide that certainty, some amount of time inevitably would be needed for clarification of the rules. Wholly apart from the impact of enactment of the legislation on the conduct of our members' businesses, for the reasons discussed above, there would be a significant risk of severe compliance issues if the effective date of any enacted legislation is not significantly delayed. Based on feedback from our members'

operational departments, depending on the complexity of the rules adopted, considerably more than a year of diligent effort is likely to be necessary to build the compliance systems necessary to administer properly the Bill's provisions – after necessary clarifications are provided by the Treasury Department. Thus, we strongly suggest that the Bill adopt an effective date that would accommodate the time period necessary for the affected dealers to properly implement systems for compliance. Congress showed similar sensitivity to operational concerns in enacting the broker tax basis reporting requirements of Section 6045(g) by providing that it would not be effective until more than two years following enactment.

Commentary and Proposed Modifications Relating to the Criteria for Designation as a Transaction Exempt from the Bill's Provisions as Not Having a Tax Avoidance Purpose:

A major concern of our members about the regulatory safe harbor to be established under the Bill is that the Bill, as currently written, would subject all equity swaps to withholding tax prior to the creation of the anticipated safe harbor for non-tax-avoidance transactions. Even if the implementation issues discussed above are disregarded, it would simply be unfair and unduly disruptive to the markets to allow withholding tax to be imposed for some interim period on transactions that are considered not to have a tax-avoidance purpose. For this reason as well, ISDA's members urge a delay in the effective date of the Bill.

In creating a regulatory safe harbor, we note that there are differing approaches that might be taken. For example, a safe harbor might require meeting minimum requirements with respect to each of several enumerated factors, meeting minimum requirements with respect to some subset of these factors, or perhaps meeting more stringent requirements for only one or two of the factors. We would be pleased to discuss these or other alternatives with you. Below is a discussion of the five characteristics listed in the Bill that the Treasury Department might consider for exempting certain equity swaps from the provisions of the Bill. The feedback comes primarily from discussions with equity traders and users of equity swaps about developing a "safe harbor" that will achieve the Congress' and Treasury's overall objective of eliminating abusive transactions, without harming legitimate business.

1. "the term of the swap (including provisions for terminations and offsetting financial contracts)"

ISDA members have different views about whether a minimum term for a swap is necessary or appropriate factor to require for a safe harbor. Some members oppose any minimum term as unduly intrusive to a significant volume of legitimate non-tax motivated transactions. Other members would agree that there are legitimate transactions with short terms, but understand the rationale for requiring an economically significant term.

The tax law recognizes a variety of time periods as economically significant in differing circumstances. Under Section 901(k), a taxpayer must hold an equity unhedged for a period of more than 15 days in order to be entitled to a foreign tax credit with respect to dividends received. Similarly, the Section 1091 wash sale rules prohibit a current loss from being taken on the sale of a security where the taxpayer has reacquired the same security during a 30-day period following the sale of the security. Finally, the minimum holding period under Section 246 for claiming a corporate dividends-received deduction is only 46 days of unhedged exposure to the underlying stock. The Greenbook Proposal would have adopted a 90 day period, which is longer than that required by all of the foregoing provisions. Nonetheless, many equity swaps are traded in and out on a frequent

basis purely as a matter of strategy, and 30 days of exposure is economically significant. Given these requirements, if a minimum term requirement were adopted, our view is that a minimum term of 30 days is a reasonable indication of the lack of a tax avoidance purpose, striking a balance that would achieve Congress' and Treasury's intended purpose without forcing a majority of market participants to significantly alter their trading strategies.

The parenthetical reference in the Bill to early terminations and offsetting contracts reflects recognition that the stated term of a swap will not necessarily be the appropriate measure of its term for purposes of the Bill. We believe the relevant period generally should be the actual term of the swap, with certain exceptions. In addition, for this purpose, if the same parties to a swap or related parties enter into another swap that offsets the swap in question, the entering into of the offsetting swap should be treated as ending the term of the swap in question for this purpose. In contrast, if a minimum term is required to qualify for a safe harbor, a non-U.S. counterparty could easily enter into such an offsetting transaction, and the original U.S. counterparty would have no way of knowing about that offsetting transaction. The non-U.S. counterparty would thus circumvent a holding period requirement if the purpose of the holding period requirement is to impose a minimum holding period of exposure to the referenced equity and not to the swap itself. In any event, if a transaction with a third party could be treated as ending the term of a swap for purposes of the Bill (which would be eminently reasonable in this context), while is might be appropriate for the Bill to subject the non-U.S. counterparty to tax under Section 871, under no circumstances should a withholding obligation be imposed on the U.S. counterparty to the original swap.

Exceptions from using the actual term of the swap should be made in certain circumstances. One such case is where a termination of the swap results from an occurrence that is not in the control of either party. In these circumstances, the stated term rather than the actual term should be used. For example, the stated term should be used where one party exercises a termination right following the bankruptcy of the other party, the issuer of the underlying referenced share entering into a merger, making a tender offer or engaging in certain other corporate events, as well as other termination events that are in neither party's control. On the other hand, if one party has an unconditional right to terminate a swap, or if the parties mutually agree to a termination, it is appropriate to use the actual term. Exceptions from using the actual term also would be appropriate in a number of other cases, and we would be pleased to discuss those cases with you.

2. "the amount of each party's investment and the amounts of any collateral posted"

This factor appears to have superseded a provision contained in the Greenbook Proposal that would have imposed a 20 percent maximum on the amount of collateral required. The Bill also introduces the concept of each party's "investment," which was not contained in the Greenbook Proposal. We assume that "investment" for this purpose essentially means any upfront payment made by a party, as such a payment effectively is a substitute for collateral, and we would like to see clarifying language in either the Bill's statutory language or its legislative history.

In general, ISDA's members believe that a factor based on the amount of an upfront payment or amount of collateral required should be clear and unambiguous in its application, yet have a certain amount of flexibility given the myriad circumstances that might be encountered in the market. As an initial matter, we suggest that the maximum be set at 40%. This requires all equity swaps to still have higher leverage than Reg. T generally allows, but will give credit/risk management departments needed discretion to mitigate risk in a large proportion of cases. Nonetheless, we recommend that higher amounts be considered acceptable where a dealer can demonstrate that its credit policies and procedures resulted in such higher amount, and the higher amount would have

been applied in otherwise similar circumstances that would not implicate withholding on dividend-related payments, in effect providing a rebuttable presumption of a 40% maximum.

We have a number of suggestions for clarifying rules relating to determining how much collateral is required for a particular equity swap. First, in measuring the amount of collateral posted, the valuation "haircuts" customarily applied by the bank for posted collateral in similar circumstances should be given effect. For example, a swap has a notional amount of $1000 and a 40% collateral requirement. The counterparty wishes to post as collateral high grade corporate bonds, and the dealer customarily applies a 10% haircut to this class of asset in determining whether collateral targets are met. Accordingly, the dealer would require approximately $444 worth of corporate bonds to meet its collateral requirements. Under these circumstances, the 40% maximum requirement should be considered to be met and not exceeded. We note that consistent with normal credit practices, a particular dealer's haircut for a given class of collateral may vary depending on whether the arrangement under which the collateral is posted allows the dealer unconditionally to sell or rehypothecate the collateral.

Second, a maximum collateral requirement should be based only on the amount of "initial margin" required by a dealer from a counterparty to enter into the swap, as of inception of the swap. Initial margin is the amount of collateral that a counterparty must post in respect of the swap upon its execution. Thus, collateral that is posted (or not released) on account of changes in the value of the swap or the posted collateral, or changes in the notional amount of a swap pursuant to its terms, should not be taken into account. Otherwise there would need to be significant changes in normal market practices to monitor the requirement. Moreover, there would be no potential for abuse of the maximum requirement provision, since a dealer is unlikely to accept initially less collateral than it otherwise would require against the hope of becoming adequately collateralized due to changes in values.

Third, only the minimum collateral that the dealer requires to be posted should be taken into account. If a counterparty for some reason posts more collateral than required or fails to withdraw all the collateral that it might be entitled to withdraw, the requirement should not fail to be satisfied.

Fourth, in determining the amount of collateral required to be posted toward any maximum, collateral that is held by a third party custodian, and non-cash collateral that the dealer is not entitled to sell, rehypothecate or otherwise monetize absent a default, should not be taken into account. Where the collateral is so held, it does not serve as a source of funding for the dealer provided by the customer. Without funding from the customer, a transaction is far less likely to have any abusive element. Thus, we would propose that if a maximum collateral requirement is adopted, then regardless of what amount of collateral a dealer may require, a transaction would be considered to satisfy the requirement so long as the actual collateral posted, after taking into account applicable haircuts, but excluding collateral held by a third party custodian is less than the maximum collateral requirement. We note that such a provision would not affect a significant number of ISDA's members, but would facilitate legitimate transactions in a number of circumstances without inviting abuse.

3. "whether the price of the equity used to measure the parties' entitlements or obligations are based on an objectively observable price"

Certain market measures such as "official opening price", "official closing price" and the daily "volume weighted average price" certainly are objectively observable. We recommend that there be clarification of other market measures that might not so clearly come within the meaning of this

requirement. In particular, we would like to discuss the following measures:

a. Volume weighted average price measured over a specified minimum time period
b. Price based on high/mid/average of dealer quotes
c. Fixed price (*e.g.,* a dollar amount, such as $21.50/share) established in advance of dealer execution (*e.g.,* at inception or termination)
d. "Execution pricing," which is the price at which a dealer's hedge is either established or terminated, and which we discuss in # 5 below

4. "whether either party sells (directly or indirectly) to the other party the security giving rise to United States source dividend income"

ISDA's members agree that this factor is appropriate. Nevertheless, the need for very clear rules regarding this factor is critical, and we wish to discuss with you precisely what transactions would be considered to constitute the indirect purchase of stock from or sale of stock to the counterparty. For example, we should discuss the circumstances under which a swap's use of certain objectively observable prices such as "official opening price" or "official closing price," or use of a third party broker can create an indirect sale.

5. "whether there are terms that address the hedge position of either party or other conditions that would compel either party to hold or acquire the security giving rise to United States source dividend income"

On its face, this indicates that a dealer is prohibited from making any of the terms of the swap subject to the performance of a transaction that the dealer may enter into to hedge its exposure under the swap. Where an equity swap contract permits the dealer to terminate the swap due to the underlying equity being placed on a dealer's restricted list or an SEC insider list, unfavorable changes in law, or customary hedging disruption or similar events, these provisions should not be considered to reflect the swap's having a tax avoidance purpose. Similarly, the standard provision allowing a dealer to pass on an increase in the cost of financing its hedge positions should not be considered evidence of a tax avoidance purpose. References to the underlying equity security under circumstances such as these in no way undermine the primary purpose of the Bill of distancing the equity swap from ownership of the underlying equity security and should therefore be permitted. For your reference, the attached exhibit contains standard language in ISDA documentation that implements the provisions described in this paragraph. We would be happy to discuss any concerns that you may have regarding use of this language.

ISDA's members also believe that a swap should be permitted to refer to the dealer's hedge position to the extent necessary to allow the use of so-called "execution pricing" in relation to establishing the opening price of a swap. Most, but not all, members also believe that it should be permissible for the closing price of a swap to be based on execution pricing. Execution pricing refers to a price that is based on the verifiable price at which a dealer who is going to hedge its position under the swap, actually executes its hedge positions, or for a dealer who has entered into a hedge of a swap, the verifiable price at which the dealer terminates the hedge. Since execution prices are established in open market trades made at the time of the dealer's choosing (which may be in consultation with but not controlled by its counterparty), execution pricing is not indicative of the dealer's having directly or indirectly acquired the referenced equity security from its counterparty. Accordingly, an equity swap that uses execution pricing effectively ensures that a counterparty cannot without risk convert a physical position in an equity security into a synthetic position (and vice

versa), avoiding a situation that presents an acknowledged concern. Moreover, the dealer's execution prices will be objectively observable and verifiable, and therefore consistent with the standard in # 3 above.

Other comments

As written, the Bill would impose withholding tax on certain payments under equity swaps referencing an index such as the S & P 500. ISDA's members believe that transactions involving an index or basket of equities are inherently non-abusive since the equity securities in a sufficiently diversified index or basket may or may not pay dividends and will have varying dividend payment dates that may or may not come within the term of the swap. Accordingly, we would propose creation of an exception so that no withholding tax would be imposed with respect to payments on a swap relating to an index or basket of equity securities. We wish to discuss with you how to define appropriately such an index or basket. Such an exception would best be implemented through the adoption of statutory language. However, a workable approach to the issue would be for regulations to indicate that this type of equity swap would not be subject to the Bill's provisions without regard to the applicability of any other factors, provided our recommendations regarding the effective date of the Bill are adopted (so that there is no period where the provisions of the Bill would apply to such swaps because of the absence of regulations creating an appropriate exception). Two issues for discussion are whether the index must provide for deemed automatic reinvestment of dividends (as opposed to discrete payments of dividend amounts), i.e., a total return index, in order to qualify for such an exception, and what kind of anti-abuse provision might be appropriate depending on the how the excepted index or basket is defined.

In addition, as written, the Bill would apply to all notional principal contracts that reference a U.S. equity security. Although the rationale for the Bill is clear enough in the case of payments under notional principal contracts (or "substantially similar" payments as specified in regulations) that create a position essentially identical to owning the referenced security, we do not believe the Bill should apply to any number of equity swaps that would be treated as notional principal contracts but do not closely resemble ownership of the referenced equity security. For example, an equity swap or similar contract might give a counterparty only a limited interest in the appreciation or depreciation in value of the referenced equity. Under the terms of such a swap, any payment ultimately made might or might not be affected by dividend payments. In order to distinguish equity notional principal contracts that should be subject to the provisions of the Bill from those that should not, we recommend that the constructive ownership standard of Section 1260 be adopted. Thus, we propose an amendment to the statutory language so that an equity swap would not be subject to the provisions of the Bill if it did not meet the standard for being treated as a "long position under a notional principal contract" within the meaning of Section 1260(d)(1)(A).

The provisions of the Bill would create the potential for multiple impositions of withholding tax with respect to a single physical dividend payment. The potential for multiple withholding taxes is very real for a number of our members. In particular, it is common for a non-U.S. entity to enter into an equity swap with a counterparty and then enter into an identical offsetting equity swap with a U.S. affiliate. In this situation, the Bill would subject payments on both of these equity swaps subject to withholding tax. Accordingly, we recommend exempting from the provisions of the Bill any equity swap between related parties that can be matched with an equity swap between one of those parties and an unrelated third party.

Finally, we also would like to discuss two other provisions of the Bill. First, we would like to discuss the provision that would make both counterparties to an equity swap withholding agents for

any payments that the Bill would subject to withholding. We are unsure of the purpose of this provision since the non-U.S. counterparty would be substantively liable for any tax that the U.S. counterparty failed to remit as withholding agent. Second, we would like to discuss how the key definitional language "any payment . . . that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend," might be clarified.

Once again, we appreciate the opportunity to have our views considered and look forward to having a constructive dialog concerning this important legislative matter.

Sincerely yours,

Thomas Prevost
Chair,
ISDA North American Tax Committee