

HIRE Act Introduces Significant US Tax Law Changes

March 22, 2010

On March 18, 2010, US President Barack Obama signed into law the Hiring Incentives to Restore Employment Act (the "HIRE Act"). The Act incorporates a number of revenue raisers, including provisions that will (i) re-source "dividend equivalent" payments under certain equity swaps and stock loans over stock of US corporations, (ii) impose stringent due diligence and reporting requirements on non-US financial institutions in respect of foreign accounts owned by certain US persons and US-owned foreign entities, and (iii) affect certain obligations issued in bearer form by both US and non-US issuers. The tax changes introduced by the HIRE Act are very significant and will severely impact non-US persons, especially financial institutions and funds.

Withholding Tax on Payments under Certain US Equity Derivatives

Current law provides that payments to foreign persons on notional principal contracts referencing stock of US corporations are generally treated (absent a recast of the transaction) as foreign-source income and, therefore, not subject to US withholding tax. This is in contrast with the treatment of a regular dividend on portfolio US stock held by a foreign person, which would generally be subject to withholding tax (that could be decreased by a tax treaty). The HIRE Act seeks to harmonize the withholding tax treatment of these two alternative investments by treating, under new Code section 871(l), "dividend equivalent" payments as US source income subject to withholding. The HIRE Act also addresses a perceived abuse in the use of certain stock loan structures to avoid US withholding tax based on prior Internal Revenue Service ("IRS") guidance.

"Dividend Equivalent Payments"

The HIRE Act defines a "dividend equivalent" as (i) any substitute dividend made pursuant to a securities lending or sale-repurchase transaction that references, or is contingent on, dividends paid from US sources, (ii) any payment under a "specified notional principal contract" that references, or is contingent on, dividends paid from US sources, or (iii) any other payment determined by the Treasury Department to be substantially similar to the first two types of payments.

Under the HIRE Act, a "specified notional principal contract" has, in essence, two definitions. First, for payments made on or after September 14, 2010 (the date that is 180 days after the enactment date), a specified notional principal contract is defined as any notional principal contract¹ that meets one of the five tests below:

- in connection with entering into such contract, any "long party"² to the contract transfers the "underlying security"³ to any "short party"⁴ to the contract (*i.e.*, a "cross-in");
- in connection with the termination of such contract, any short party to the contract transfers the underlying security to any long party to the contract (*i.e.*, a "cross-out");
- the underlying security is not readily tradable⁵ on an established securities market;
- in connection with entering into such contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract; or
- such contract is identified by the Secretary as a specified notional principal contract.

After March 18, 2012, however, a specified notional principal contract will be defined as *any* notional principal contract, "unless the Secretary determines that such contract is of a type which does not have the potential for tax avoidance."

¹ Under Treasury Regulations section 1.446-3(c)(1) a notional principal contract is defined as a financial instrument that provides for the payment of amounts by one party to another, at specified intervals, calculated by reference to a specified index upon a notional principal amount, in exchange for specified consideration or a promise by the counterparty to pay similar amounts.

² A "long party" is defined as any party to the notional principal contract which is entitled to receive any payment pursuant to such contract which is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States with respect to an "underlying security."

³ "Underlying security" is defined, with respect to any notional principal contract, as the security with respect to which the dividend equivalent is paid. The term is discussed in more detail below.

⁴ A "short party" is defined as any party to the notional principal contract which is not a long party with respect to an underlying security.

⁵ Although not defined in the HIRE Act, it is presumed that the definition of such term in Treasury Regulations section 1.1273-2(f) will be used for this purpose.

The limited definition of a specified notional principal contract for the period ending March 18, 2012, addresses concerns of the financial industry that proper Treasury guidance would not have been available on the effective date of the provision (such contemporaneous guidance being required under prior drafts of this provision). By providing for a temporary "safe harbor" in the form of a narrow definition of a specified notional principal contract, the HIRE Act, while not permanently addressing these concerns, does remove some of the immediate uncertainties surrounding the potential application of the new rule.

Taxpayers should be aware that, as set forth in the Joint Committee on Taxation's explanation of this provision in a prior bill ("JCT Explanation"),⁶ it is possible that the Treasury Department may publish retroactive guidance identifying additional specified notional principal contracts, with effect from September 14, 2010. The JCT Explanation further provides that, notwithstanding the introduction of this provision in the HIRE Act, general US tax law relating to agency and beneficial ownership still will apply to prior, existing and future swap transactions (*i.e.*, a "no inference statement"). Consequently, banks and other market participants may be reluctant to loosen certain of their existing swap guidelines intended to mitigate the risk of application of these rules. This would appear true even though factors addressed in these guidelines and specifically referred to in prior legislation and the Treasury Department's General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (commonly referred to as the "2009 Greenbook")⁷ as relevant in determining whether a specific swap was abusive were not ultimately included in the HIRE Act (*e.g.*, the minimum term requirement and the limit on the amount of collateral posted by the long party).

The HIRE Act defines the term "underlying security" to mean, with respect to any notional principal contract, the US security with respect to which the US source dividend referred to in the dividend equivalent payment is paid. Any index or fixed basket of securities is treated as a single security for this purpose. In applying this rule, the JCT Explanation provides that it is intended that such a security will be deemed to be regularly traded on an established securities market only if every component of such index or

⁶ Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act," Under Consideration by the Senate (JCX-4-10), February 23, 2010, available [here](#).

⁷ The 2009 Greenbook was released May 11, 2009. It is available [here](#).

fixed basket is a security that is readily tradable on an established securities market. As discussed above, the definition of a specified notional principal contract includes contracts the underlying security of which is not readily tradable on an established securities market. Therefore, if a swap contract references an index or fixed basket of US stock that is not readily tradable and every component of such index or fixed basket of securities also is not readily tradable, under the HIRE Act this contract would be a specified notional principal contract.

Prior IRS Pronouncements on US Equity Swaps

The approach adopted in the HIRE Act to re-source dividend equivalent payments under total return swaps where there is a sale of the underlying stock by the long party to the short party (*i.e.*, a cross-in) or a sale of the underlying security from the short party to the long party at termination (*i.e.*, a cross-out) stands in contrast with recent IRS audit guidelines ("IDD") for swap transactions released on January 14, 2010. In the IDD, the IRS directed the field to examine total return swaps where there is both a cross-in *and* a cross-out. The IDD specifically provided that field agents should not pursue a transaction where there is a cross-in but no direct or indirect cross-out (except where other facts warrant further investigation). Therefore, two separate standards have arguably developed: one, more lenient, for US equity swaps terminating prior to September 14, 2010 (which are subject to the IDD), and a more stringent one for total return swaps with payments falling after that date (which are subject to re-sourcing under the HIRE Act).

Scope of Future Guidance

It remains uncertain what will constitute a specified notional principal contract under Treasury Department guidance. In the 2009 Greenbook, a safe harbor was proposed that would not have changed the source of payments under a US equity swap with a 90-day or greater term and certain other characteristics (*e.g.*, 20 percent collateral limit, no cross in or out, and 20 percent of the 30-day average daily trading volume swap limit). Whether these factors or variations thereof will be used in future guidance is unclear.

If a minimum term is ultimately imposed, some commentators and financial services groups have argued that 90 days is an unduly long period. Other sections of the Internal Revenue Code dealing directly or

indirectly with the issue of beneficial ownership provide for shorter holding periods.⁸ The 90-day term requirement also arguably is inconsistent with (and perhaps unworkable in the context of) normal trading strategies of non tax-motivated market participants. It also is unclear how the term of the swap would be measured for this purpose (*e.g.*, actual number of days elapsed in the relevant swap or maximum term as set forth in the relevant swap confirmation).

The 2009 Greenbook also proposed that no more than 20 percent of the notional principal amount was to be posted as collateral for the swap. No distinction was made, however, between collateral borrowed by the short party and collateral that could not be so borrowed. Practitioners also have argued that if the purpose of the requirement was to ensure that the swap's borrowing component constituted a significant business purpose, a 40 percent collateral limit also could be reasonable (because it would still be below the 50 percent regulatory limit on margin straight borrowing). Several technical concerns also will have to be addressed in respect of this limitation if it is included in future regulatory guidance.⁹

Questions also remain regarding any potential Treasury Department guidance dealing with the pricing of the swap. For instance, does the Treasury Department intend to require the use of a specific pricing method (*e.g.*, one-day variable weighted average pricing ("VWAP") or risk bidding) and disallow others such as "market on close"?

The Secretary would have the authority to make other types of contracts that are not notional principal contracts (as defined in Regulations), but provide for returns similar to dividend equivalent payments, subject to the re-sourcing rule. The JCT Explanation provides that a forward contract or other financial contract that references stock of a US corporation could become subject to future Treasury Department guidance under this grant of authority. It is uncertain when the Secretary might issue guidance exercising this authority. However, it would seem likely that any extension of the rules described above to forward contracts or other financial contracts would apply on a prospective basis.

⁸ For instance, sections 246 (addressing the dividends-received deduction) and 901 (imposing certain limitations on foreign tax credits) require a 45-day holding period (a longer period is required for certain preferred stock).

⁹ These concerns include whether, if a collateral limitation is included, the collateral test will apply only to the initial margin or the margin through the term of the swap (*i.e.*, "variation margin") and whether securities posted as collateral should be valued for this purpose taking into account "haircuts" normally used by dealers in their operations.

Amount Subject to Withholding

Importantly, practitioners have argued that, even if withholding were to apply to swap payments made under a re-sourcing rule, the amount subject to withholding should be the amount actually paid to the long party, net of any financing payment made by such party. The HIRE Act takes the opposite approach, requiring withholding on the gross amount of the dividend equivalent payment.

Treatment of Stock Loans, Repos and Chains

As discussed above, the HIRE Act also provides that a "substitute dividend" made pursuant to a securities lending or sale-repurchase transaction that references, or is contingent on, dividends paid from US sources constitutes a US source dividend equivalent payment. This rule is consistent with the current sourcing rule in the Regulations but repeals, or significantly restricts, the exemption from "cascading" withholding set forth in Notice 97-66,¹⁰ which Congress felt created a tax avoidance opportunity.

As, in essence, a replacement for Notice 97-66, the HIRE Act provides that, in the case of a chain of dividend equivalents, one or more of which is subject to tax under the HIRE Act, the Secretary may issue guidance to reduce such tax. Importantly, this relief would be available only if the taxpayer can establish that such tax has been paid with respect to a prior payment in such chain (including, for this purpose, by withholding on the actual dividend on the underlying US stock) or is not otherwise due. Several questions arise from this provision, including how a taxpayer may satisfy the proof of withholding requirement, especially where there is a long chain of contracts linked by dividend equivalent amounts.

The HIRE Act provides that the Secretary may issue Regulations as appropriate to address the role of financial intermediaries in such a chain,

¹⁰ 1997-2 C.B. 328. Notice 97-66 was published to address concerns that the US sourcing rule for substitute payments could cause the total US withholding tax imposed in a series of securities lending or sale and repurchase transactions to be excessive (*i.e.*, a "cascading" effect). Certain taxpayers have taken the position that the Notice allows the complete elimination of withholding taxes in certain circumstances. See, *e.g.*, United States Senate, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, *Dividend Tax Abuse: How Offshore Entities Dodge Taxes on US Stock Dividends*, Staff Report, September 11, 2008, pp. 18-20, 22-23, 40, 47, 52; 2009 Greenbook, p. 37.

which may provide some relief to those institutions entering into swaps and stock loans as intermediaries to facilitate positions for their customers.

Importantly, no relief appears available until the Treasury Department issues the relevant guidance, which may create double or greater taxation of dividend equivalent payments in the interim period. Until such guidance is issued, there may be a level of market disruption.

Effective Date

Two final, and important, issues raised by the proposed re-sourcing rule relate to its effective date. First, the re-sourcing provision will apply to payments that occur on or after September 14, 2010. Accordingly, market participants will be required to quickly put in place administrative and IT measures to ensure compliance with the provision and minimal disruption to their activities. Some financial institutions have suggested that it might be extremely difficult to implement all of the required changes within this time frame.

Second, the HIRE Act does not contain a grandfathering provision for payments made pursuant to derivative contracts entered into prior to its effective date. Therefore, the provision requires that dividend equivalent payments on contracts that are already outstanding be subject to withholding and potential gross-up by the short party (based on standard market documentation for swap and securities loans transactions). This gross-up obligation may cause payers to either seek early termination or re-negotiate the terms of these contracts which may cause disruption in the market. Market participants will have to carefully review each of their swap or stock loan positions that mature after September 14, 2010, to confirm whether or not they are subject to the re-sourcing provision.

Provisions Relating to 30 Percent Withholding Tax on Non-US Financial Institutions, Reporting

In General

The HIRE Act imposes a 30 percent withholding tax on certain payments to non-US "financial institutions," unless these institutions agree to identify certain US account holders and provide information regarding these persons to the IRS. Foreign financial institutions that currently participate in a "Qualified Intermediary" ("QI") program will have to meet the

requirements of the HIRE Act in addition to any other requirements imposed under such QI program.

The 30 percent withholding tax will be imposed on all "withholdable payments," which includes US source interest (including original issue discount), interest on deposits with foreign branches of a domestic commercial bank (which is otherwise non-US sourced income), dividends, rents, salaries, wages, and other fixed or determinable annual or periodical gains or profits. It also includes the gross proceeds from the sale of stock or debt obligations issued by US persons. The definition, however, excludes income effectively connected with a US trade or business, which should exempt from withholding most payments to a US branch of a foreign financial institution.

The withholding tax will be imposed without regard to reduced withholding rates under any otherwise applicable income tax treaty. If a treaty would apply to the payment, the beneficial owner will have to request a refund with appropriate documentation demonstrating eligibility for a reduced rate of withholding tax. To the extent that the beneficial owner of the payment is a foreign financial institution, any withholding would only be creditable or refundable to the extent required by a treaty obligation and no interest will be paid with respect to such credit or refund. Furthermore, no credit or refund will be paid unless the beneficial owner provides certain information to the Secretary.

Certain recipients are exempted from the withholding tax, including foreign governments, international organizations, foreign central banks, and any class of persons or payments posing a low risk of tax evasion, as identified by the Secretary.

Withholding on Payments to Financial Institutions

Each non-exempt "foreign financial institution" will be subject to the 30 percent withholding tax unless it meets specified reporting and diligence requirements with respect to each "United States account" or elects to be treated as a US financial institution. In the latter case, the foreign financial institution will have to report such information with respect to each United States account under sections 6041 (information at source), 6042 (returns regarding payments of dividends and corporate

earnings and profits), 6045 (returns of brokers), and 6049 (returns regarding payments of interest) as if it were a US financial institution.

Furthermore, a foreign financial institution is deemed to meet the reporting rules of the HIRE Act if it either (i) complies with procedures prescribed by the Secretary to ensure that it does not maintain "United States accounts" and meets other requirements prescribed by the Secretary with respect to accounts held by other foreign financial institutions, or (ii) is a member of a class of institutions to be determined by the Secretary. It is anticipated that the Secretary will permit certain classes of widely held collective investment vehicles to be deemed to meet the requirements of the HIRE Act.

It is important to understand the breadth of the legislation. The provisions apply to any foreign financial institution, whether or not such financial institution maintains accounts for US beneficial owners. A foreign financial institution has to agree to the new reporting and diligence regime, elect to be treated as a US financial institution, or divest itself of assets that give rise to US source income in order to avoid the 30 percent withholding tax. The potential withholding cost will be exacerbated if this withholding tax is not creditable in the jurisdiction of the foreign financial institution.

The term "foreign financial institution" includes entities traditionally viewed as financial in nature, such as foreign banks and brokerage houses, as well as entities that are not so traditionally viewed, such as foreign hedge funds, private equity funds, and other investment vehicles. A foreign financial institution includes any entity that (i) accepts deposits in the ordinary course of a banking or similar business, (ii) as a substantial portion of its business, holds financial assets for others, or (iii) is engaged primarily in the business of investing, reinvesting, or trading in stock, notes, or other securities (as defined in section 475(c)(2)), as well as partnership interests, commodities, or any interest (including a futures, forward contract or option) in such securities, partnership interests, or commodities (an "investment vehicle").

The term "United States account" is similarly broad, meaning any "financial account" that is held by one or more "specified United States

persons" or "United States owned foreign entities" (defined below).¹¹ With respect to any financial institution, a financial account includes any depository or custodial account maintained by such financial institution, as well as any equity or debt interest in such financial institution (other than interests which are regularly traded in an established market). Interests that are not usually associated with the term "financial account" also are subject to reporting. For example, interests in foreign hedge funds and foreign private equity funds are included within the scope of the legislation.

"Specified United States persons" include all United States persons, other than certain persons who are not viewed as presenting a significant tax avoidance threat.¹² A "United States owned foreign entity" is any foreign entity that has one or more substantial United States owners. Substantial United States owners generally include any specified United States persons that own, directly or indirectly, either (i) more than 10 percent of the stock of a corporation (determined by vote or value), (ii) more than 10 percent of the profits or capital interests of a partnership, or (iii) any interest in a hedge fund, private equity fund, or other investment vehicle.

Any foreign financial institution that does not elect to be treated as a US financial institution for tax reporting purposes will be subject to the 30 percent withholding tax unless it agrees, on behalf of itself and its expanded affiliated group:¹³

¹¹ In order to eliminate duplicative reporting requirements, the term does not include any financial account in a foreign financial institution if (i) such account is held by another financial institution that meets the reporting requirements of the HIRE Act or (ii) the holder is otherwise subject to information reporting requirements which the Secretary determines would make the reporting duplicative. The term also excludes financial accounts held by a natural person if the aggregate value of all accounts held by that person at the financial institution does not exceed \$50,000.

¹² Excluded persons include publicly traded corporations or subsidiaries thereof, section 501(a) tax-exempt organizations, individual retirement plans, the United States, any state, or any wholly owned agency or instrumentality thereof, banks, real estate investment trusts, regulated investment companies, common trust funds, and trusts exempt under section 664(c) or described in section 4947(a)(1).

¹³ A corporation is part of an expanded affiliated group if it is included in an affiliated group, as determined for section 1504(a) purposes by replacing references to at least 80 percent ownership with references to more than 50 percent ownership. In addition, a partnership is included in an expanded affiliated group if the partnership is controlled, within the meaning of section 954(d)(3), by members of such group.

- (1) to obtain information from each of its account holders to determine whether such accounts are United States accounts;
- (2) to comply with the verification and due diligence procedures required by the Secretary with respect to the identification of United States accounts;
- (3) to report annually for any United States account (i) the name, address, and taxpayer identification number of any account holder that is a specified United States person and, in the case of any account holder that is a United States owned foreign entity, the same information with respect to each substantial United States owner, (ii) the account number, (iii) the account balance or value, and (iv) except to the extent provided by the Secretary, the gross receipts and gross withdrawals or payments from the account;
- (4) to deduct and withhold 30 percent from any "passthru payment" (defined as any withholdable payment or other payment to the extent attributable to a withholdable payment) that is made to (i) a "recalcitrant account holder,"¹⁴ (ii) another financial institution that does not enter into an agreement with the Secretary, or (iii) a foreign financial institution that has elected to be withheld upon rather than to withhold with respect to the portion of the payment that is allocable to a recalcitrant account holder or to foreign financial institutions that do not have an agreement with the Secretary;¹⁵

¹⁴ For this purpose, a recalcitrant account holder is any account holder that fails to comply with reasonable requests for certain information or fails to provide a waiver of any foreign law that would prevent the foreign financial institution from reporting any required information.

¹⁵ The obligation to deduct and withhold on "passthru payments" does not apply if the foreign financial institution making the payment has elected to be withheld upon rather than to withhold with respect to the portion of the payment that is allocable to a recalcitrant account holder or to foreign financial institutions that do not have an agreement with the Secretary. Should the foreign financial institution elect out of its obligation to withhold, however, it would still be subject to the information reporting requirements of the HIRE Act. To make such an election, the foreign financial institution will have to (i) notify the withholding agent with respect to each withholdable payment of its election and "such other information as may be necessary for the withholding agent to determine the appropriate amount to deduct and withhold from such payment" and (ii) waive any right under any US tax treaty with respect to any amount deducted and withheld pursuant to the election.

- (5) to comply with any request made by the Secretary for additional information with respect to any United States accounts maintained by such financial institution; and
- (6) either to obtain a waiver from account holders when foreign law would prevent the disclosure of the required information or to close the relevant account.

If a foreign financial institution fails to meet the terms of its agreements, the Secretary is authorized to terminate the agreement and impose the 30 percent withholding tax.

Other Foreign Entities

A 30 percent withholding tax also will be imposed on any withholdable payment to any foreign entity that is not a financial institution (as defined above) if such foreign entity, or another non-financial foreign entity, is the beneficial owner of the payments, unless the beneficial owner or the payee provides the withholding agent with (i) either a certification that the beneficial owner does not have any substantial United States owners or the name, address, and taxpayer identification number of each substantial United States owner of such beneficial owner, (ii) the withholding agent does not know, or have reason to know, that any such information is incorrect, and (iii) the withholding agent reports such information to the Secretary.

Certain payees are exempt from the withholding for non-financial institutions, such as publicly traded corporations (and certain corporate affiliates thereof), foreign governments and international organizations. It is important to note that the exception for publicly-traded entities does not extend to the withholding provision for financial institutions. A publicly-traded bank will, thus, be subject to the withholding and reporting regimes for financial institutions introduced by the HIRE Act.

Effective Date

The provisions relating to the 30 percent withholding tax and reporting alternatives generally apply to withholdable payments made after December 31, 2012.

Payments in respect of debt obligations outstanding on March 18, 2012, and the gross proceeds from any disposition of such an obligation, are exempt from these rules. Importantly, based on this language, payments of interest made after December 31, 2012, on amounts drawn after March 18, 2012, may be subject to withholding under these provisions even if the related credit agreement or revolving facility pre-dates March 18, 2012. This will cause taxpayers and advisors to start renegotiating "gross-up" provisions in current loan agreements if there is a possibility that amounts could be drawn by a US borrower under these facilities after March 18, 2012. It also is to be expected that the gross-up provisions of future revolving and credit facilities will have to be modified to account for the new regime.

Repeal of Foreign-Targeted Exceptions to Registration Requirement for Debt Obligations

The HIRE Act includes provisions that will affect certain obligations issued in bearer form by both US and non-US issuers.

Current Treatment

Bearer bonds, which lack formal registration identifying their holders, allow investors to remain anonymous, potentially providing non-compliant US beneficial owners with an opportunity for tax avoidance.

Current US tax law significantly restricts the issuance of bearer bonds. In order to avoid detrimental US tax implications, a debt obligation is required to be in registered form (a "Registration-required Debt Obligation") unless it (i) is made by a natural person, (ii) matures in one year or less, (iii) is not of a type offered to the public, or (iv) is a "foreign-targeted obligation."¹⁶ A foreign-targeted obligation is a debt obligation that (i) is designed to be sold (or resold in connection with the original issue) only to non-US persons, (ii) only pays interest outside the United States, and (iii) has a legend stating that US persons who hold the obligation will be subject to

¹⁶ An obligation generally is treated as issued in registered form if the right to the principal of and stated interest on the obligation can be transferred only through a book-entry system maintained by the issuer or its agent. See sections 163(f)(3) and 149(a); see also Treasury Regulations section 5f.103-1(c).

limitations under US income tax laws, including the limitations in sections 165(j) and 1287(a) (the "Statutory TEFRA Exception Requirements").¹⁷

Regulations implementing the Statutory TEFRA Exception Requirements introduced two alternative procedures, known as "TEFRA C" and "TEFRA D," to ensure that a debt obligation will be treated as foreign-targeted. Under the so-called "TEFRA D" rules, the legend described above must be included on the debt obligation and (i) the issuer and distributor cannot offer or sell the obligation during a restricted forty-day period to a person within the United States or to a US person, (ii) during such restricted period, neither the issuer nor any distributor may deliver the obligation in definitive form within the United States, and (iii) certain certifications must be produced on the earlier of the date of the first payment of interest on the obligation or the date of delivery by the issuer of the obligation in definitive form.¹⁸ Under the "TEFRA C" rules, no legend is required if a bearer bond is issued only outside the United States by an issuer that does not significantly engage in interstate commerce with respect to the issuance of such bond and interest on such bond is payable only outside the United States.¹⁹

A Registration-required Debt Obligation that is not in registered form is subject to substantial sanctions. US and non-US issuers of such an obligation are subject to an excise tax equal to 1 percent of the principal amount of the obligation multiplied by the number of calendar years (or portion thereof) from the issuance date until maturity.²⁰ If the issuer does not pay the excise tax, (i) gain on the sale or other disposition of the debt obligation by a US holder will be treated as ordinary income, and (ii) any loss on such transaction will not be deductible.²¹

In addition to the 1 percent excise tax, a US issuer of such an obligation is denied a deduction for interest paid or accrued thereon.²² From a foreign

¹⁷ Section 163(f)(2)(B); Treasury Regulations section 1.163-5(c)(1)(ii)(B).

¹⁸ Treasury Regulations section 1.163-5(c)(2)(i)(D).

¹⁹ Treasury Regulations sections 1.163-5(c)(1)(ii)(A), 1.163-5(c)(1)(ii)(B), 1.163-5(c)(2)(i)(C).

²⁰ Section 4701.

²¹ Sections 165(j), 1287(a); Treasury Regulations section 1.165-12(a).

²² Section 163(f). Although this limitation also technically applies to a foreign issuer, it would only have an adverse tax effect if such issuer were engaged in a US trade or business to which this expense could be allocated.

holder's perspective, interest paid or accrued on a Registration-required Debt Obligation issued by a US person that is not in registered form is subject to a 30 percent withholding tax (subject to reduction under an applicable income tax treaty). This interest does not qualify for the portfolio interest exception.²³

Changes Introduced by the HIRE Act

As discussed below, the HIRE Act renders the use of bearer bonds by US issuers even more disadvantageous by repealing several of the prior important exceptions to the registration requirement for foreign-targeted obligations.²⁴

The HIRE Act preserves the exception to the registration requirement for excise tax purposes provided, generally, that the current Statutory TEFRA Exception Requirements are satisfied. In the absence of further guidance, the HIRE Act requires all bearer bonds (including bonds issued by non-US issuers to non-US investors) to comply with all Statutory TEFRA Exception Requirements, including the legend requirement, to benefit from the excise tax exemption.

Relevant to US issuers, the HIRE Act repeals the foreign-targeted obligation exception as applied to the denial of interest deductions on bonds not issued in registered form, and the tax exemption on interest on State and local bonds not issued in registered form. It also denies the benefit of the portfolio interest exception to interest paid by US issuers on bearer obligations, irrespective of whether the obligations are offered only to foreign persons. Subject to the discussion below regarding dematerialized book-entry systems, this requirement will compel US persons only to issue registered bonds and collect IRS Forms W-8 from holders to meet the requirements for zero percent withholding on US source interest under the portfolio interest exception. The HIRE Act, however, authorizes the Secretary to waive the obligation to collect forms when it is "not required in order to carry out the purposes" of the provision. It is anticipated that the Secretary may waive this requirement in circumstances where there is a low risk of tax evasion and there are

²³ Sections 871(h)(2), 881(c).

²⁴ The HIRE Act also repeals a provision in Title 31 of the U.S. Code that currently permits the US government to issue foreign-targeted obligations in bearer form.

adequate documentation standards in the beneficial owner's country of tax residency. This is a welcome grant of additional authority to the Secretary.

Apparently as a means to decrease the impact of the repeal of the various foreign targeted exceptions, the HIRE Act confirms that a "dematerialized" book-entry system will be treated as a book-entry system that satisfies the registration requirements. Under such a system, a debt obligation that is formally issued in bearer form will nonetheless be treated as issued in registered form (and hence will avoid the detrimental tax consequences described above) as long as the debt obligation may be transferred only by book entry and the holder of the obligation does not have the ability to withdraw the obligation from the book-entry system and obtain a physical certificate in bearer form in the ordinary course of business. It appears, however, that further clarification of this rule may be needed. Recently, commentators, including the Tax Section of the New York State Bar Association, have pointed out that the use of the term "dematerialized book-entry system" may be too narrow.²⁵ It is apparent that the rule was intended to cover a structure involving a "global note" issued in "physical," bearer form and traded through a clearing house, although such an obligation is not fully "dematerialized." To address this concern, the HIRE Act provides that the Secretary is authorized to specify other book-entry systems that satisfy the registration requirement.

Effective Date

The bearer bond provisions are effective for debt obligations issued after March 18, 2012.

Other Revenue Raising and Foreign Compliance Provisions

The HIRE Act also includes new disclosure requirements for individuals with an interest in certain specified foreign financial assets. Specifically, the HIRE Act provides that individuals with an interest in certain specified foreign financial assets during any taxable year must attach a disclosure statement to their income tax return for any year in which the aggregate value of all such assets is greater than \$50,000. To the extent provided by the Secretary, the provision also applies to any domestic entity formed or availed of for purposes of holding such specified foreign financial assets.

²⁵ See New York State Bar Association Tax Section, *Comments on the Foreign Account Tax Compliance Legislation* (Report No. I1199, Jan. 11, 2010), available [here](#).

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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In addition, the HIRE Act imposes new penalties on any understatement attributable to an undisclosed foreign financial asset, introduces a new 6-year limitations period for assessment of tax on understatements of income attributable to foreign financial assets, requires each US person who is a shareholder of a "passive foreign investment company" (PFIC) to file an annual information return, clarifies when a foreign trust has a US beneficiary, treats the uncompensated use of foreign trust property as a distribution for US tax purposes, and imposes new reporting requirements for US owners of foreign trusts.

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