

January 10, 2011

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Grandfathering Rules in the HIRE Act and Notice 2010-60

Dear Commissioner Shulman:

Enclosed are comments on grandfathering rules in the HIRE Act and Notice 2010-60 . These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,



Charles H. Egerton
Chair, Section of Taxation

Enclosure

cc: Michael F. Mundaca, Assistant Secretary (Tax Policy), Department of the Treasury
William J. Wilkins, Chief Counsel, Internal Revenue Service
Jeffrey Van Hove, Acting Tax Legislative Counsel, Department of the Treasury
Stephen E. Shay, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury
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**ABA SECTION OF TAXATION
COMMENTS ON GRANDFATHERING RULES IN
THE HIRE ACT AND NOTICE 2010-60**

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Michael Hirschfeld of the U.S. Activities of Foreigners and Tax Treaties Committee of the Section of Taxation. Substantive contributions were made by Rachel Kleinberg, Jennifer Morgan, and David Shapiro. The Comments were reviewed by Alan I. Appel, Committee Chair. The Comments were further reviewed by Fred Murray of the Section’s Committee on Government Submissions and by Joan Arnold, Council Director for the U.S. Activities of Foreigners and Tax Treaties Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who may be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: January 10, 2010

EXECUTIVE SUMMARY

These Comments address certain issues raised by the Hiring Incentives to Restore Employment Act¹ (the “HIRE Act”), and Notice 2010-60² (the “Notice”), and are in response to a request for comments made by the Internal Revenue Service (the “Service”) in the Notice.

Section 501 of the HIRE Act, by adding sections 1471 through 1474 of the Code,³ imposes new information reporting regimes for certain payments made to foreign entities, which are enforced by a new withholding tax regime on payments made to those entities.⁴

The reporting and concomitant withholding are effective as of January 1, 2013, but do not apply to payments made on or with respect to certain obligations outstanding on March 18, 2012 (the “Grandfathering Rule”).⁵

The HIRE Act provides authority for the Service and the Department of the Treasury (“Treasury”) to provide guidance for the implementation of the statute.⁶ These Comments include recommendations and suggestions with respect to the implementation of the Grandfathering Rule for revolving credit agreements as follows:

- We recommend that guidance provide that revolving credit agreements that include a fixed maturity date (“revolvers”) be treated as obligations, and that revolvers entered into prior to March 18, 2012, are eligible in full for the Grandfathering Rule, irrespective of the dates on which draw-downs under the revolvers are made. If Treasury and the Service are concerned about abusive situations, we recommend an anti-abuse rule covering revolvers entered into with a principal purpose of avoiding Chapter 4 withholding, with safe harbors for: (1) revolvers entered into prior to the earlier of the date of Proposed or Temporary Regulations or the date of a notice describing intended Regulations; (2) revolvers entered into with regulated lenders, such as banks; and (3) revolvers entered into with unrelated persons that are regularly engaged in a lending business.

¹ Pub. L. No. 111-147, § 501, 124 Stat. 71 (2010).

² 2010-37 I.R.B. 326.

³ References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

⁴ Collectively, sections 1471 through 1474 comprise chapter four of subtitle A of the Code, entitled “Taxes to Enforce Reporting on Certain Foreign Accounts.” Hereinafter, the reporting and withholding regime imposed by this new chapter is referred to generally as the “Chapter 4 regime.” To distinguish the new withholding tax imposed by this new chapter from withholding taxes imposed by other sections of the Code, the new withholding tax is referred to as the “Chapter 4 withholding tax.”

⁵ HIRE Act § 501(d)(2).

⁶ See, e.g., I.R.C. §§ 1471(b)(2)(B), 1471(d)(5), 1471(f)(4), 1472(c)(2).

- We recommend that if the terms of a revolver are amended, and the amendment would constitute a “significant modification” if the revolver were drawn down in whole or in part, then such an amendment should be treated as a “material modification” with respect to the revolver and the revolver should no longer be grandfathered.
- If Treasury and the Service do not grant a “blanket” grandfathering rule or impose conditions on reliance on the “blanket” grandfathering rule, we recommend that the balance outstanding under the revolver on March 18, 2012 be eligible for the Grandfathering Rule without any conditions. We also recommend that in such a case, (i) borrowings and repayments under the revolver be treated under the terms of the revolver, or (ii) if the revolver is silent as to the order of repayments, a “first in-first out” rule be applied to determine the outstanding balance under the revolver that remains eligible for the Grandfathering Rule.

COMMENTS

I. Overview of the Grandfathering Rule

Sections 1471 and 1472 impose withholding taxes on certain payments made to foreign entities.⁷ These provisions generally are effective for payments made after December 31, 2012.⁸ However, these provisions do not apply to any payments made on obligations outstanding on March 18, 2012 (the “Grandfathering Date”) or to the gross proceeds from a disposition of any such obligation.⁹

Section I of the Notice states that Treasury and the Service intend to define “obligation” to mean “any legal agreement that produces or could produce withholdable payments” other than equity or an agreement that lacks a definitive term. Section I further states that Treasury and the Service intend to treat any obligation entered into on or before the Grandfathering Date as outstanding on the Grandfathering Date for purposes of the Grandfathering Rule. If any such grandfathered instrument is subject to a “material modification” after the Grandfathering Date, the Notice provides that the grandfathered instrument will no longer qualify for the Grandfathering Rule. The Notice states that in the case of a debt instrument, a “significant modification” will be treated as a material modification. The Notice further provides that for all other obligations, the existence of a “material modification” will be determined based on all facts and circumstances.

II. Treatment of Revolving Credit Agreements as “Obligations”

We applaud the definition of “obligation” in the Notice. We believe that the definition in the Notice is broad enough to include a revolving credit agreement with a finite term. There remains, however, a lack of certainty as to whether such an agreement is an obligation, or whether only amounts borrowed under the agreement constitute obligations. We recommend that the agreement as a whole be viewed as an obligation.

A revolver is an agreement pursuant to which a borrower has a right to borrow a maximum amount and a lender is obligated to loan up to that maximum amount, but the full amount typically is not borrowed (“drawn down”) at the time the parties enter into the agreement. Instead, the borrower will draw down on the revolver as required to fund business operations and will repay principal when excess cash is available. Any principal so repaid becomes available for future borrowing, provided that the borrower remains in compliance with its covenants under the revolver.

The Service and Treasury might treat an amount drawn down on a revolver as an “obligation” within the meaning of the Grandfathering Rule, as clarified by the Notice.

⁷ I.R.C. §§ 1471(a), 1472(a).

⁸ HIRE Act § 501(d)(1).

⁹ HIRE Act § 501(d)(2).

Pursuant to an agreement, a lender has advanced money to a borrower with a requirement that the borrower repay the advance. Such a draw is in many ways similar to any other borrowing with a fixed maturity and is distinguishable from a demand deposit or savings account because the draw has a finite life.

We recommend, however, that the Service and Treasury clarify that a revolver is itself an obligation, even though each draw-down also may be viewed as an obligation, because the revolver is the contract that creates the conditions, requirements and payment obligations that apply for the entire term of the revolver. That is, each draw-down under a revolver is governed by the single legal agreement that applies to the entire revolver. No additional terms are negotiated and no separate legal agreement is entered into in order to affect any individual draw under a revolver. Thus, we believe the single legal agreement governing the entire revolver should be treated as “the legal agreement that produces or could produce withholdable payments” as provided in the Notice and all draws made pursuant to that agreement should be treated as part of a single obligation.

Treating the revolving credit agreement itself as an obligation would advance some of the important purposes that we believe motivated the inclusion of the Grandfathering Rule: the avoidance of undue economic hardship to borrowers and other obligors currently subject to contractual arrangements; an allowance of additional time for parties to make prospective arrangements to deal with the new regime; and an allowance of the benefit of bargains arranged before the finalization of new rules and Regulations. For example, revolvers typically have change-in-law gross-up provisions and in some cases have gross-up provisions that also cover withholding taxes in existence on the date of the agreement. Draw-downs may be made after March 18, 2012, under a revolver whose terms were fixed prior to March 18, 2012 (or even prior to March 18, 2010), but ordinarily the gross-up provisions governing payments on those draws will not be revisited in connection with making the subsequent draws. Those terms were fixed on the date the revolver itself was entered into.

Accordingly, a revolver entered into prior to March 18, 2010, (and potentially a revolver entered into since that date) generally would require a borrower to make a gross-up payment with respect to any Chapter 4 withholding tax and may otherwise contain insufficient provisions regarding compliance with the Chapter 4 regime. Absent the grandfathering of such revolvers, borrowers that draw down on such revolvers after March 18, 2012, might be subject to such gross-up payments, materially increasing the cost of borrowing under the revolvers. Alternatively, borrowers might amend the agreements to include provisions regarding compliance with the Chapter 4 regime, potentially creating artificial market pressures as many borrowers seek to refinance existing credit agreements earlier than they ordinarily might.

Furthermore, it may be very costly for a borrower to terminate an existing revolver and enter into a new one or to obtain an alternative source of funding, because the cost of borrowing has increased from the time that many existing revolvers were put into place. In addition, if a borrower already has a significant amount of debt in place (*e.g.*, because the revolver was put in place in conjunction with other leverage), the borrower may not be able to borrow, other than through a draw on an existing revolver,

without renegotiating the entire debt package. For a borrower that is no longer creditworthy, refinancing may not be an option at all.

If an additional draw under an agreement that provides a gross up provision is not covered by the Grandfathering Rule, then depending upon the lender group (which often is not within the borrower's control due to syndication of loan obligations), the effective interest rate on the draw may be significantly increased to produce a net yield after Chapter 4 withholding equal to the stated interest rate on the revolver.

Example: Assume that a borrower entered into a revolver with an FFI on February 1, 2010, that includes a "gross-up" provision that would require the borrower to increase payments so that the FFI would receive, after any Chapter 4 withholding, a net amount equal to the amount the FFI would have received if Chapter 4 had not been enacted. Assume that draws under the revolver are not grandfathered. Assume a \$100,000,000 draw and a 6% interest rate. If Chapter 4 withholding did not apply, the borrower would be required to pay \$6,000,000 in interest per year. However, if Chapter 4 withholding applies, then because of the "gross-up" provision, the borrower would be required to pay \$8,561,428, for an effective interest rate of over 8.56% - representing an increase of 42.8% over the intended 6% cost.

Given the potential costs to borrowers, we recommend that Treasury and the Service include revolvers in the definition of "obligation," thereby allowing such agreements the full benefit of the Grandfathering Rule.

We acknowledge that inclusion of revolving credit agreements within the Grandfathering Rule might be subject to abuse. For example, parties might enter into a revolver on the Grandfathering Date, specifically to qualify for the Grandfathering Rule, and without any intention of drawing down the revolver until long after the Grandfathering Date. However, we believe that there usually would not be an incentive for a borrower to enter into a revolver for this purpose. In our experience, the costs and fees associated with negotiating and implementing a new revolver provide a deterrent to entering into a new revolver for a non-business purpose. In addition, we believe other timing considerations such as the projected need for cash, when an old revolver will expire, anticipated changes in interest rates, or an expectation that its credit ratings will rise or fall, seem more likely to drive a borrower's decision as to when to enter into a revolver. Finally, a borrower may not expect to bear the burden of Chapter 4 withholding taxes with respect to revolvers entered into after the Grandfathering Date and therefore may not be concerned with finalizing a revolver prior to that date.

If Treasury and the Service remain concerned about the potential for abuse, we believe that this concern should be addressed by including an anti-abuse provision excluding from the Grandfathering Rule revolvers entered into with a principal purpose of the avoidance or evasion of the Chapter 4 regime. If Treasury and the Service adopt such an anti-abuse rule, we also recommend that two safe harbors be created.

First, we recommend a safe harbor for revolvers entered into prior to the date of any Proposed or Temporary Regulations. Although the HIRE Act was adopted in March

2010 and taxpayers have had some time to consider its implications, the statute leaves so much to regulatory and administrative interpretation, it is difficult for taxpayers to determine how they may comply until Regulations and other administrative guidance are issued. We therefore recommend that a safe harbor be based on the publication date of Proposed or Temporary Regulations (or other guidance) rather than on the date the statute was enacted. If Treasury and the Service believe that a narrower safe harbor is warranted, we suggest an earlier cut-off date, such as the date of the Notice. Although Treasury and the Service might consider grandfathering only revolvers (as opposed to other types of obligations) entered into before the date of enactment of the HIRE Act, we note that in our experience, borrowers who entered into revolvers after that date but before March 18, 2012, will have relied on the expectation that the revolver would be grandfathered and will not have attempted to insist upon protective language. Those who were able to insert some protective language may find that it is not sufficient to address the procedures that are ultimately adopted for Chapter 4 withholding.

As noted above, typically there are significant costs associated with entering into a revolver with a mainstream lender and we believe it is unlikely that taxpayers would do so for non-business reasons. We therefore recommend a second safe harbor, covering revolvers entered into after the date of Proposed or Temporary Regulations, which revolvers are entered into with a regulated lender, such as a bank, or an unrelated lender that makes loans in the ordinary course of its business. We believe that this additional safe harbor is justified based on the significant costs involved and our belief that unrelated businesses who are in the day to day business of lending are unlikely to attempt to be parties to arrangements that are meant to make abusive use of a grandfather date.

If these recommendations are adopted and all borrowings under certain revolvers are treated as grandfathered, then we recommend that Treasury and the Service clarify that any modification to the terms of the revolver that would constitute a “significant modification” of drawn-down amounts, if any, would be treated as a “material modification” of the revolver, whether or not any amounts actually are drawn down after the modification.

III. Treatment of Payments and Draws under Revolvers

As discussed above, balances under revolvers fluctuate regularly, as the borrower draws down the revolver to fund capital needs and repays the revolver out of excess cash flow. As a result, we anticipate administrative complications if a revolver entered into before the Grandfathering Date is not itself subject to the Grandfathering Rule and instead only draws made prior to the Grandfathering Date under such a facility are grandfathered.

As an initial matter, a borrower that draws on a single revolving credit facility both before and after the Grandfathering Date would find that the portion of its obligations attributable to the grandfathered draws would not be subject to Chapter 4 withholding, while the portion attributable to the post-Grandfathering Date draws would be subject to Chapter 4 withholding. If, in a common scenario, the borrower then repays a portion, but not all, of its obligation under the facility, the borrower then would have to

determine what portion of its future payments would continue to be grandfathered and what portion would be subject to Chapter 4 withholding. Many revolvers specifically address this issue, most commonly adopting a first-in, first-out (FIFO) ordering system.

In the absence of a rule grandfathering the entire revolver if it is entered into either on or prior to the Grandfathering Date, we recommend that the Service and Treasury establish an ordering system that borrowers may apply to determine the extent to which subsequent principal payments are considered to reduce grandfathered draws and non-grandfathered draws. We suggest that a reasonable and administratively feasible solution would be to apply the ordering system specified in the revolver, and if the revolver does not specify an ordering system, apply the more commonly used FIFO ordering system. Under a FIFO ordering system, any principal payments would be applied first to reduce the earliest draws under a facility and only once the grandfathered draws are repaid would the principal repayment be subject to Chapter 4 withholding. We believe adopting such a system would reduce confusion and inconsistency among taxpayers attempting to comply with the Chapter 4 regime.

Examples of how such an approach might work, assuming that draws on or before March 18, 2012, are grandfathered and that the revolver specifies FIFO repayment or is silent on the order of repayment, follow:

Example 1: Borrower enters into a revolver with a bank in early 2011, with a maximum principal amount of \$100 million. Borrower draws down on the revolver to fund working capital needs in 2011 and early 2012. On March 18, 2012, the outstanding principal balance on the revolver is \$40 million. Borrower does not borrow any further amounts under the revolver. The full \$40 million drawn under the revolver is grandfathered.

Example 2: Same facts as Example 1, but Borrower draws down another \$10 million in June 2012. All interest payments attributable to the period prior to the June 2012 draw and 80% (\$40 million of pre-Grandfathering Date borrowings divided by \$50 million total borrowings) of interest payments attributable to the period following the June 2012 draw would be exempt from Chapter 4 withholding.

Example 3: Same facts as Example 2, but Borrower repays \$10 million of borrowings in August 2012. The principal repayment would not be subject to withholding because there was a total of \$40 million of pre-Grandfathering Date borrowings. In addition, 75% (\$30 million of remaining pre-Grandfathering Date borrowings divided by \$40 million of total remaining borrowings) of future interest payments would be exempt from Chapter 4 withholding.