The new rules of the game


UNDER THE US FOREIGN ACCOUNT TAX COMPLIANCE ACT, THE TAX GROSS-UP RULES FOR CROSS-BORDER SYNDICATED LOANS HAVE CHANGED. **JACK L HEINBERG** AND **MIKE LAYFIELD** EXPLAIN THE ISSUE, AND LOOK AT WHAT TREASURERS CAN DO.

Until recently, the rules of the game were fairly well settled when negotiating the tax gross-up provisions of a cross-border syndicated loan. It was, for instance, widely understood that a nation would impose withholding tax only on payments sourced to that nation under its domestic tax law. It was also widely understood that the parties could more or less sidestep the withholding tax issue by ensuring that the lending syndicate consisted of banks or other entities eligible for an exemption under a tax treaty or other relief provision.

To address the possibility that the borrower might nevertheless have a withholding obligation at some point (for example, because of a change in law), the parties spelled out in the loan agreement the circumstances under which the borrower would have a corresponding tax gross-up obligation. The borrower's gross-up obligation might be broad or narrow depending on the parties' relative bargaining power, but at least each side clearly understood the risk over which they were negotiating.

With the 2010 enactment by the US of the Foreign Account Tax Compliance Act (FATCA), however, the rules of the game have changed considerably. Once fully implemented, FATCA will create a new US withholding regime applicable not only to payments of traditional US-source investment income (e.g. payments by a US borrower), but also to certain payments that would not be considered US-source under the usual rules.

The requirement to withhold on this latter category of payments marks a significant departure from the traditional withholding tax framework in cross-border syndicated loans. Ultimately, it may require not only non-US borrowers but also facility agents and lenders to withhold and pay over tax to the US Internal Revenue Service (IRS) for payments sourced to another nation.

FATCA AND LOAN SYNDICATION

BACKGROUND The FATCA withholding rules are intended to incentivise non-US financial institutions (FFIs) to report certain information about their US account holders to the IRS. In very general terms, it works by imposing a 30% gross-basis withholding tax on "withholdable payments" and certain "passthru payments" made to FFIs that do not enter into an agreement with the IRS that they will:

- report certain information about their US account holders to the IRS; and
- withhold on passthru payments they make to other FFIs that fail to report US account holder information to the IRS.

A lender that enters into an IRS agreement as required by FATCA will be considered a "participating FFI" and should enjoy an exemption from the FATCA withholding tax.

The term "withholdable payment" refers to traditional US-source investment income, as well as gross proceeds from the disposition of property of a type that can produce US-source investment income. Since a disposition of property includes repayment of debt for these purposes, the second prong of the withholdable payment definition means that principal repayment by a US borrower may be subject to the FATCA withholding tax.

The term "passthru payment", meanwhile, is defined by statute to include any payment by a participating FFI to the extent that it is "attributable to a withholdable payment". Innocuous as it seems, this definition was interpreted broadly in early guidance to require withholding on payments that are not US-source under the traditional sourcing rules. Subsequent proposed regulations under FATCA have rowed back on this definition, calling into question whether and to what extent non-US source payments ultimately will be subject to FATCA withholding at all.

Adding to the confusion, the US recently announced its intention to begin negotiations with foreign governments (including the UK, France, Italy, Spain and Germany) over an intergovernmental approach to FATCA implementation that may drastically reshape the withholding framework just described.

Because of the widespread confusion engendered by these rules, the US has agreed to phase in the various FATCA withholding requirements over time. FATCA withholding on traditional US-source investment income will begin on 1 January 2014, while withholding on gross proceeds from the disposition of property of a type that can produce US-source investment income begins on 1 January 2015.

In a nod to the complexity of the passthru payment concept, withholding on such payments will not begin before 1 January 2017.

Importantly, under grandfathering rules no withholding will be required at all in the case of loan agreements that were signed before 1 January 2013 unless the parties materially modify the agreement after that date. For these purposes, the addition or removal of a borrower or guarantor could be considered a material modification, as could other seemingly routine amendments commonly made in syndicated deals.

In addition, a loan facility will not be grandfathered if the parties do not agree its material terms before 1 January 2013. This may be an issue for some facilities which, although contemplated by loan agreements entered into before 1 January 2013, are not fully agreed until after that date (e.g. ancillary facilities, and facilities with accordion features that contemplate the possibility of future commitment increases).

> AN INDEMNIFICATION OBLIGATION FOR INTRA-SYNDICATE PAYMENTS COULD EXPOSE THE BORROWER TO SEVERE FINANCIAL STRAIN THAT JEOPARDISES ITS ABILITY TO REPAY.

FATCA TODAY With this overview in mind, how should a prospective borrower approach FATCA when negotiating a syndicated loan?

The first thing to note is that FATCA withholding generally will not apply to loans finalised in 2012 that are not materially modified post-2012. Consequently, the borrower should never be called on, as a practical matter, to gross up its lenders for any FATCA withholding on these loans (although if grandfathering is lost, the borrower may find it has to gross up some payments under standard tax gross-up provisions).

While it may be tempting to omit FATCA-specific gross-up language entirely in this situation, it may nevertheless be prudent to condition certain provisions of the loan agreement, such as those governing changes to the obligors and amendments, on the inclusion of appropriate FATCA language.

Where the parties envisage a post-2012 modification of a loan signed in 2012, they may decide to negotiate their FATCA positions at the outset rather than risk returning to the bargaining table later in a potentially weaker position. The considerable uncertainty surrounding FATCA may frustrate their efforts, however.

2013 AND BEYOND The FATCA stakes will be raised considerably on 1 January 2013 because any loan agreement signed or modified on or after that date will be subject to FATCA withholding in accordance with the implementation schedule described above. Careful and informed negotiations over the borrower's FATCA gross-up obligation will therefore become critically important for both parties, even though significant uncertainty remains regarding key aspects of the law.

This uncertainty notwithstanding, current market practice suggests that the allocation of the FATCA withholding tax risk will depend on a number of considerations, the most important of which include the composition of the borrowing group, the composition of the lending syndicate, and the maturity date of the loan. The remainder of this article discusses how these considerations are likely to shape the FATCA gross-up negotiations for European syndicated loans signed after 2012.

Where a loan agreement includes either a US entity or a participating FFI as a borrower, lenders will typically want to ensure that the agreement's tax gross-up clause takes into account the possibility that payments from that borrower could be subject to FATCA withholding. Additionally, because under either scenario FATCA withholding may apply to disbursements of interest, principal and other amounts by the agent to members of the syndicate, lenders will probably want to expand the borrower's gross-up obligation to cover withholding on these payments as well.

FATCA withholding may also apply to payments made between members of the syndicate since these could be passthru payments under the current proposed guidance. While it is beyond the scope of this article to describe in detail the application of FATCA withholding

to intra-syndicate payments, it is worth noting that lenders may demand indemnification for amounts withheld on these payments. Since this indemnification obligation would be in addition to any gross-up obligation for payments made by the borrower and the agent, borrowers and lenders should consider at the outset whether the syndicate will include lenders that would trigger withholding in the first instance.

Without appropriate limits on syndicate membership, an indemnification obligation for intra-syndicate payments could expose the borrower to severe financial strain that jeopardises its ability to repay the loan. Unfortunately, parties may not be in a position to fully assess the risk of passthru withholding on loans with long-dated maturities unless final FATCA regulations are issued this year.

MARKET TRENDS As a matter of commercial practice, a market position has started to emerge concerning the extent of a borrower's gross-up obligations for FATCA withholding. This position may change, of course, as market participants acquire a better understanding of the law's requirements, particularly with respect to passthru payment withholding once final regulations are issued. For now, however, lenders within the European syndicated loan market generally expect at a minimum a gross-up for any FATCA withholding with respect to payments made by the borrower and the facility agent. Some lenders have also insisted that the borrower indemnify them for any FATCA withholding on intra-syndicate payments. Whether these positions are adopted in a given loan agreement obviously depends on the relative bargaining power of the parties, but they send a clear signal of lender sentiment at the moment.

Parties may also consider other steps to manage FATCA risk in their loan agreements. One such step is simply to exclude US borrowers from the borrowing group whenever possible, thereby eliminating US-source payments on which FATCA withholding will be required, starting 2014. Similarly, the parties may wish to exclude participating FFIs as borrowers, the payments from which are subject to passthru withholding starting as early as 2017.

Of course, neither of these steps may be feasible from the borrower's perspective, and in any event would not eliminate the risk of passthru withholding on intra-syndicate payments. To address this risk, the borrower may seek the right to force the removal or resignation of any facility agent or lender whose presence results in FATCA withholding, particularly if such withholding is accompanied by a corresponding gross-up or indemnity obligation.

BE PREPARED While much remains uncertain about the full scope of FATCA's new withholding regime and its application in the syndicated loan market, there can be no doubt that it adds an entirely new dimension to the negotiation of future loan agreements. Borrowers should start familiarising themselves with the basic issues outlined in this article before it is time to tap the credit markets. Otherwise, they may be unprepared to play by the new rules of the game.

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