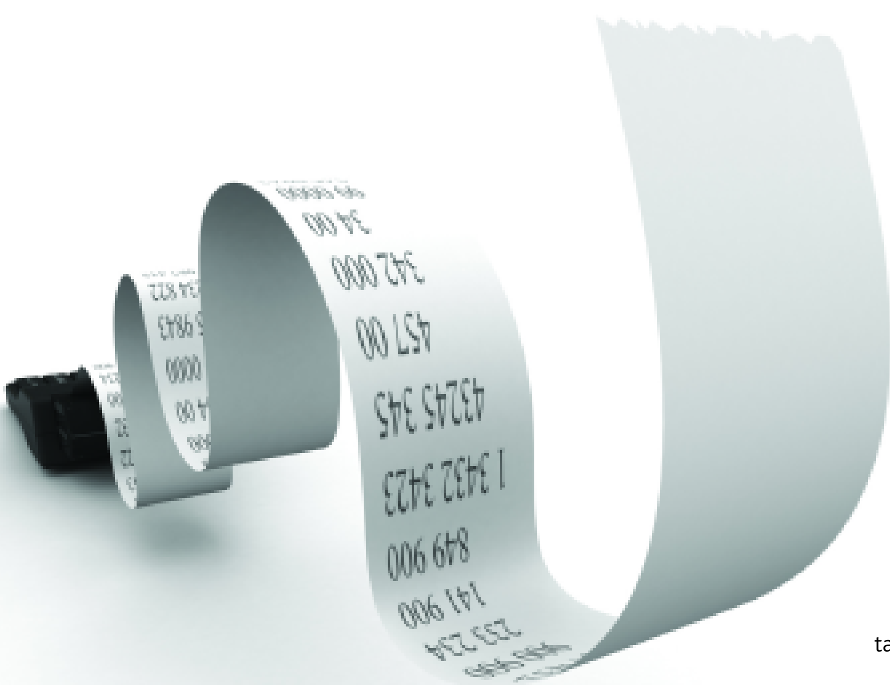
Who pays?

DEAN NAUMOWICZ AND **ANDREW ROYCROFT** EXPLAIN HOW RECENT INNOVATIONS BY NATIONAL TAX REGIMES ARE UNDERMINING STANDARD-FORM DOCUMENTATION FOR LOANS, SWAPS AND DERIVATIVES.

Globalisation is one of the major trends of 21st century business. It has touched practically every industry and changed the way business is conducted. One of the often neglected features has been an increasing standardisation of tax systems – and some convergence of tax rates. Across the globe, countries impose similar types of tax (corporate income taxes, withholding taxes, etc) on similar tax bases (profits, interest, etc), using similar concepts to define the territorial scope of those taxes (residence, permanent establishments, etc).

That standardisation has allowed provisions in standard-form documents to apply with only limited (if any) tailoring to a wide range of transactions, including cross-border transactions. Tax gross-ups and indemnities in ISDA (International Swaps and Derivatives Association) master agreements and LMA (Loan Markets Association) facility agreements in particular benefit from such standardisation.



However, the ripples of the credit crisis have seen the global tax environment undergo some significant changes. Governments are looking to use tax to encourage certain behaviour, to discourage other behaviour and to raise revenue. Some countries have proposed new taxes, some of which swim against the tide of standardisation.

When the cost of these taxes is allocated in a commercial transaction, common standard-form documentation can produce surprising results. Below, we consider two such taxes.

US DIVIDEND WITHHOLDING TAXES The US Hiring Incentives to Restore Employment Act is one of the more recent examples. It contains a number of tax changes, including a rule to "re-source" certain payments to the US. It treats payments under certain swap and stock loan transactions[1] over shares in US corporations as being US-source income and, apparently, will require US withholding tax to be paid for "dividend equivalent" payments under certain types of transactions. In broad terms, this seems to catch payments referable to dividends paid on the underlying US shares.

This withholding tax will be payable even though the only connection to the US may be that the swap or stock loan relates to shares in a US company. It seems there is no requirement for either party to the swap or stock loan to be resident in the US or have any presence in the US. Although there might be practical difficulties in enforcing such a tax against a person who has no presence in the US, this should not be overstated. It is not safe to assume that the US will not be able to enforce its taxes outside the US, as many countries now recognise exceptions to the principle that one country will not enforce another country's taxes.

The tax is a novel development, because the purpose of withholding taxes is to allow the country in which income arises (the source country) to collect tax on that income from a person within the reach of the enforcement powers of the source country's tax authority. Withholding taxes are typically applied to income which is mobile – dividends, interest, etc – specifically because it can easily be owned by someone with no link to the source country, and who is beyond the reach of the source country's tax authority.

It makes sense to transfer the responsibility for paying tax on such income to the person who pays the dividend,

interest, etc, because that person is far more likely to be present – and have assets – in the source country. The cost of the tax is passed on to the owner of the income, by virtue of it being deducted from the payment the owner receives.

But where the person paying the income has no link to the jurisdiction imposing the tax, there is little reason to transfer liability for paying the source country tax from the owner of the income to the person paying that income. This raises the question of who should bear the cost of such a withholding tax imposed by a jurisdiction that neither party may have any link with.

GROSS-UP OBLIGATIONS The standard ISDA documentation requires the party that makes a payment to gross up that payment for any withholding taxes that are "indemnifiable taxes". Basically, indemnifiable taxes are any taxes other than those imposed because of a present or former connection between the jurisdiction imposing the tax and the person receiving the payment.

If the recipient of a payment under a derivative transaction that represents a dividend on a US share has no link to the US, the ISDA documentation places the burden of the withholding tax on the person making that payment, who must gross the payment up for the withholding tax. This risk allocation makes sense in a world where withholding taxes are imposed on a person who has chosen to be subject to a country's withholding taxes by being resident or having some other presence there. But where the payer's only link to the US is to own shares in a company incorporated there, there is less force in the argument that he or she should bear the cost of that withholding tax. This is particularly true if the recipient could not have received a dividend paid by the underlying US shares free of US withholding tax and was attempting to circumvent this by transferring the shares to a counterparty with whom the recipient subsequently entered into a total return swap transaction.

ISDA responded to this by publishing a protocol on 23 August that allows parties to ISDA Master Agreements to sign up to a set of amendments to those ISDA Master Agreements. This will require the recipient of a dividend equivalent payment that is subject to the withholding tax to bear the cost of such a tax and gives both parties additional termination rights. However, the protocol provides additional tax representations, including a representation to comply with US Foreign Account Tax Compliance Act (FATCA) reporting requirements, which have yet to be finalised.

While protocols have proved an invaluable mechanism to amend ISDA Master Agreements and certain types of trade confirmations over the past few years, the ISDA protocol of 23 August is all or nothing, so some counterparties may instead prefer to negotiate more tailored amendments to their ISDA Master Agreements.

BANK LEVIES Another area of innovation is bank levies. The UK and others are in the process of introducing (or at least considering) levies on banks' balance sheets.

These levies are aimed, at least in part, at discouraging behaviour which some governments consider has contributed to the recent financial crisis. In the same way that duties are imposed on cigarettes and alcohol, the UK government's proposed bank levy is intended to discourage harmful behaviour; in this case, excessive risk-taking. This is to be achieved by imposing a levy on the total liabilities of certain banking groups, with the total overall levy reducing as the stability of the bank's funding increases. In this way, the levy is not imposed on tier 1 capital, insured retail deposits, repos secured on sovereign debts, and policyholder liabilities of retail insurance business.

Whatever the merits or otherwise of these taxes, they pose a number of challenges for banks and their counterparties, including who should bear the cost of them. Standard LMA documentation requires certain increased costs and taxes for the facility to be borne by the borrower. The indemnities are carefully crafted to allocate the risk of taxes between the lender and the borrower, the general principle being that the borrower is responsible for all but tax on the lender's profits in its home, or lending, jurisdiction. This drafting clearly does not contemplate the existence of taxes imposed by that jurisdiction on the bank's balance sheet. A borrower may therefore be faced with liability for a tax that it would never have envisaged as its problem on entering into the loan.

As with US withholding tax, it is at least debatable whether the risk allocation provided by standard documentation achieves an appropriate outcome. Is it really appropriate for borrowers to indemnify their lenders for the bank levies that are likely to be imposed by an increasing number of jurisdictions? Whether any bank attempts to rely on the indemnities to recover such levies from its borrowers is, of course, a different question.

Although these levies may be set at relatively low levels – a few basis points, at least initially – it would be a mistake to assume that the cost will be limited. Any bank that operates in a number of jurisdictions may find itself subject to bank levies in several countries for the same liabilities. There is, as yet, little consensus as to how – if at all – such "double taxation" should be countered. Traditionally, the country where the bank is resident would give credit for taxes imposed by other countries, but such relief may not be forthcoming. In any event, the tax payable in the resident jurisdiction may not be sufficient to cover the total bank levies payable in other jurisdictions.

WHAT TO DO Such new and innovative taxes provide a challenge for standard-form documentation. Businesses and their advisers are well advised to consider whether their commercial agreements appropriately allocate such new costs. Any changes required may not be extensive, but are nevertheless important.

There may be no right or wrong way to approach this challenge. Borrowers may want specifically to exclude the UK's bank levy from the indemnities in their facility agreements. Parties to swaps and other derivatives should consider whether adhering to the ISDA protocol of 23 August best serves their interests, or whether they need to negotiate specific amendments to cater for the recent US tax changes.

However you approach it, there's little doubt the tax environment is changing, with knock-on effects on standard-form documentation.

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Footnote
1 We understand that from 14 September until 18 March 2012 only payments under one of five types of transaction will be re-sourced. Thereafter, payments under all "notional principal contracts" will be subject to this re-sourcing rule unless the payment is under a type of contract that has been determined not to have the potential for avoidance.