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16 June, 2014

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# Tax Client Alert

# FATCA and the LMA: A Change of Approach

## INTRODUCTION

In a recent publication[1], the LMA have announced a change of approach to the allocation of FATCA withholding risk in certain of their precedent facility agreements.

Previously, the LMA had not adopted a definitive stance in this area, recognising that borrowers and lenders may wish to allocate the risk in a number of different ways and publishing a range of drafting "Riders" to reflect this possibility.[2]

In the future, however, "Rider 3", which imposes the risk of FATCA withholding on the lenders, will be included in the LMA's "investment grade" facility agreements for loan transactions that are governed by English law, i.e. as a default position.[3]

Admittedly, transaction parties will be free to modify this approach and allocate the risk differently, as the LMA suggest may be appropriate in certain circumstances in any case. The LMA's change of approach seems significant, however, and is likely to have an important impact on market practice in this area.

## BACKGROUND

FATCA is US tax legislation that can impose withholding tax on a wide range of payments both inside and outside the US.

In light of this, non-US loan documents commonly deal with what should happen if FATCA withholding ever applied to payments that are made under those documents.

In very simple terms, the question in this regard is who should bear the risk of that withholding.

[1] "2014 Summary Note on FATCA" dated 9th June 2014
[2] See the LMA publication entitled "2013 FATCA riders for LMA investment grade facility - July 2013 Update", for example.
[3] These precedent facility agreements on the LMA website had not been updated to include "Rider 3" at the time of writing. As at the date of this client bulletin, the LMA expected that this would "happen shortly".

- Should it be the borrower under a gross-up obligation in the loan documentation that extends to FATCA withholding?
- Or should it be the lenders through an express exclusion of FATCA withholding from the gross-up and other tax-related protections that the lenders enjoy under that documentation?

In the US market, the usual practice is to impose the risk of FATCA withholding on the lenders, the rationale being that the lenders can generally avoid that withholding by complying with the FATCA regime (see also below).

In non-US markets, however, the position has not been as straightforward.

This is because in certain circumstances borrowers have been forced to assume the risk of FATCA withholding under gross-up and tax indemnity provisions on the basis that, unlike US borrowers, non-US borrowers can generally control whether FATCA withholding arises in the first place (that is, by neither making US source payments under the loan agreement nor being a compliant FFI that is required to withhold under the so-called passthru regime: again, see below).

Overall, therefore, the US approach has not necessarily been followed in overseas lending markets - at least outside the bond markets where non-US issuers do routinely exclude the risk of FATCA withholding from the bonds' gross-up provisions in Milbank's experience.

### IGAS

The more difficult it is for lenders to comply with the FATCA regime and receive affected payments free of FATCA withholding, the more interested they will be in imposing that risk on their non-US borrower.

Moreover, there has been significant uncertainty in recent years as to whether lenders will be able to satisfy the information-reporting requirements that FATCA imposes and thereby comply with the regime.

The point here is that lenders will not necessarily have the requisite infrastructure and governance procedures to collect the information about US investors and account holders that FATCA generally requires them to report to the IRS in the US. Even if they do have this ability, local laws on confidentiality and data protection, for example, may prevent them from sharing this information with an overseas tax authority such as the IRS.

In turn, certain lenders have previously been keen for their non-US borrower to assume the risk of FATCA withholding, i.e. by including the withholding in the loan's

gross-up and tax indemnity provisions. They have argued that, whilst they as lenders might not be able to comply with FATCA, the non-US borrower should in most cases be able to ensure that payments made under the loan do not have a US source and are not otherwise withholdable under FATCA.

An important development in this area, however, has been the increasing number of intergovernmental agreements or "IGAs" that the US has entered into or agreed with overseas jurisdictions.

These agreements broadly come in two forms, Model 1 and Model 2, and generally seek to ensure that foreign financial institutions or "FFIs", which most commercial lenders will qualify as, are not prevented from complying with the regime by the type of obstacle mentioned above. Under the standard Model 1 IGA, for example, FFIs are required to report information about their US investors and account holders to the FFIs' local tax authorities so as to circumvent potential local law restrictions on information-reporting to overseas tax authorities. Those local tax authorities then exchange that information with the IRS.

As IGAs have made it easier for lenders based in IGA jurisdictions to comply with FATCA, so borrowers have argued that, for loans in which this type of lender is likely to predominate, the risk of FATCA withholding should be placed on the lenders.

Accordingly, in such circumstances, which might include loans made to a UK or other Western European borrower, for example, given the number of jurisdictions in Western Europe that have entered into a Model 1 IGA with the US[4], borrowers have frequently pressed for something akin to "Rider 3" of the riders that the LMA have previously published on the subject to be included in their loan agreements - that Rider expressly excluding FATCA withholding from the gross-up and tax indemnity provisions.

#### LMA PUBLICATION

Viewed in this light, the LMA's decision to adopt "Rider 3" as the default approach in their English-law-governed "investment grade" facility agreements (as explained above) can be seen as both reflecting and cementing these developments.

Indeed, consistent with this, the LMA suggest that this default approach will not necessarily be appropriate if a "Finance Party" is located "in an emerging markets jurisdiction in which it is unclear whether a Model 1 IGA will be signed", and that alternative approaches may then need to be adopted - for example, "Rider 1" of the

[4] A full list of the jurisdictions that have entered into an IGA with the US, or agreed an IGA in substance, can be found at http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA-Archive.aspx.

previous LMA Riders, which generally imposes the risk of FATCA withholding on the borrower.

The LMA also suggest it may be "best practice", even where the default approach is included in loan agreements, for the borrower to represent that it is not making US source payments, which, if correct, would generally reduce the risk of FATCA withholding ever applying to payments under the loan.

Overall, therefore, it seems that the LMA's change of approach as regards the allocation of FATCA withholding risk takes account of the IGA process previously described, whilst also reflecting the limitations of that process in terms of jurisdictions that have not yet entered into IGAs with the US. Accordingly, it should not be seen as a recommendation that Rider 3 be adopted in all LMA-style loan documentation in the future. Indeed, in certain market sectors, such as Middle Eastern project finance transactions, for example, where lenders are likely to come from what are currently non-IGA jurisdictions, the LMA's change of approach may have little, if any, relevance.

Nevertheless, if lenders do predominate from IGA jurisdictions, or the borrower's reasonable expectation is that they should predominate from those jurisdictions, it may now be difficult for lenders to argue that the inclusion of Rider 3 in the underlying loan documents is not appropriate.

### CONCLUDING THOUGHTS

The preceding discussion and the general proliferation of FATCA-related provisions in non-US finance documents might suggest that FATCA withholding is frequently an issue in relation to non-US finance-raisings.

In fact, however, this will not necessarily be the case for at least two reasons.

First, loan agreements that are entered into before 1st July 2014 will be generally grandfathered from all forms of FATCA withholding and will only lose that grandfathering if they undergo material modifications to their terms and conditions after that date.

Second, even if this grandfathering is not available, provided the non-US borrower does not make US source payments under the loan agreement, which would be relatively unusual, the borrower should only be required to withhold under FATCA if it is a FFI that is subject to the so-called passthru regime. This regime, moreover, has its own form of grandfathering in respect of foreign passthru payments, the expiry date of

which is currently unknown but which has not yet occurred[5]; does not generally require "reporting" FFIs in jurisdictions that have entered into Model 1 IGAs with the US to withhold from foreign passthru payments[6]; and is only capable of imposing withholding tax on those payments from 1st January 2017 in any case.

Understandably, however, parties to non-US loan documents often wish to accommodate the possibility of FATCA withholding applying to payments that are made under those documents and have been heavily guided to date by the LMA's suggested approaches in this area.

As the preceding paragraphs have explained, LMA have now opted for a default approach in certain of their precedent loan documentation under which FATCA withholding risk is imposed on the lenders. As has additionally been explained, however, the approach is designed to apply in particular circumstances only - broadly, where the lenders and agent are based in Model 1 IGA jurisdictions.

Nevertheless, the LMA's choice of this approach as a default position in these circumstances will inevitably strengthen a non-US borrower's bargaining position when it comes to imposing FATCA withholding risk on the lenders, even in cases that do not fit squarely within the intended parameters of the approach.

Indeed, at least in Western Europe, where a number of jurisdictions have entered into IGAs with the US, we may soon see the syndicated loan market adopting the approach that is usually adopted in bond markets in that region, i.e. FATCA withholding risk being imposed on the lenders in almost all cases.

[5] Obligations that can only produce 'foreign passthru payments' (i.e. obligations that will not produce US-source payments) will be grandfathered from this type of withholding if they are outstanding on the date that is six months after the publication of the final rules on foreign passthru payments (Treas. Reg. § 1.1471-2(b)(2)(i)(B)).

[6] See, for example, Article 4.1 of the IGA that the UK has entered into with the US, albeit that HMRC in the UK consider that the reporting obligations under Article 4(1)(b) of the IGA which replace this passthru withholding are a "short term solution to withholding on passthru payments", which is likely to be reviewed "alongside any discussions on passthru post 2017" (see the HMRC document entitled "Implementing the UK-USA FATCA Agreement, Summary of Responses" dated 18th December 2012).

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