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Tax Client Alert:
FATCA and the Syndicated Loan Market Some More Breathing Space

INTRODUCTION

The IRS have recently announced certain modifications to the well-known US FATCA regime, including a postponement of the first date on which the regime can impose withholding tax on affected payments and an extension of grandfathering from that withholding tax. Participants in the international syndicated loan markets are likely to welcome these changes, which are described in more detail in the following paragraphs.

BACKGROUND

FATCA is a US tax legislation that the non-US syndicated loan market has been forced to take account of in recent years.

This is because FATCA can potentially impose a 30% withholding tax on a broad range of payments by non-US persons, including payments that do not have a US source.

Such payments might include interest and principal payments that are made under a non-US facility agreement, for example, as well as disposal proceeds that are paid to a security agent during enforcement proceedings.

FATCA is extra-territorial legislation in other words that is increasingly being considered and provided for in non-US loan documentation – whether in the context of acquisition, project or other bank-driven financings.

RECENT DEVELOPMENTS

Given its scope and potential ambit, FATCA has been viewed as controversial by market participants from the legislation's inception.

To their credit, however, the IRS have repeatedly sought to soften the originally proposed harshness of the regime.

Their latest announcements in this regard, which they published on 12th July 2013, include the following:

- A postponement to 1st July 2014 of the earliest date on which FATCA-related withholding can apply to affected payments (the applicable date was previously 1st January, 2014).
- A general extension of grandfathering from FATCA withholding to any "obligation" (as defined for FATCA purposes) that is entered into on or before, and not materially modified after, 30th June 2014 (the applicable date was previously 31st December 2013).
- A new fiction under which an intergovernmental agreement that the US has entered into with an overseas jurisdiction is treated as effective on the date on which it first appears on a list that the US Treasury will publish on its website for this purpose – that is, rather than the date on which the agreement becomes effective under the laws of the applicable jurisdiction.

RATIONALE

These announcements generally postpone the application of the FATCA regime, as can be seen.

More particularly, however, they can be seen as an attempt on the part of IRS to buy time in certain areas so that the regime can be implemented more fairly and efficiently.

A highly important example of this relates to the intergovernmental agreements or IGAs that the US government have recently been negotiating with a range of countries.

In essence, these agreements attempt to make effective the basic intent of FATCA, which is to increase transparency as regards accounts held by US persons in non-US foreign financial institutions.

FATCA does this as a general principle by requiring these foreign financial institutions to enter into agreements with the IRS under which they undertake to provide certain information in relation to US account holders and carry out related tasks.

Moreover, if the foreign financial institutions or FFIs do not enter into these agreements and otherwise comply with the regime, they potentially suffer withholding tax at 30% on a wide range of payments.

Such FFIs may not be able to comply with the above compliance obligations, however - under local law restrictions relating to customer confidentiality and data protection, for example. They might therefore be subject to a highly unpalatable 30% withholding tax on any affected payments that they receive.

With this in mind, the US has sought to enter into IGAs with overseas jurisdictions as a means of mitigating the burden that these compliance obligations would otherwise impose upon FFIs.

Only a handful of overseas jurisdictions have entered into IGAs to date, however, which will often take time to become effective under the laws of the applicable jurisdiction in any case.

In turn, each of the IRS's recent announcements can be seen as reflecting this lack of progress: either postponing the initial application of the regime, increasing the range of agreements that are grandfathered from FATCA withholding or accelerating the date on which an IGA becomes effective under the regime once the US enters into the agreement with an overseas government.

GRANDFATHERING

Of the IRS's recent announcements in relation to FATCA, the one relating to extended grandfathering from FATCA-related withholding tax is possibly the most impactful, at least as far as the international syndicated loan markets are concerned.

The effect of the extension is that any facility agreement that is entered into on or before the postponed grandfathering date (now 30th June 2014) will generally be exempt from FATCA withholding tax.

It will not matter, therefore, whether payments that are made under the agreement are capable of being subject to FATCA withholding tax. The withholding will not be relevant in the first place.

Admittedly, this grandfathering will be lost if the terms and conditions of the facility agreement undergo material modification after 30th June 2014.

Generally speaking, however, the market now has almost a year to enter into loan agreements that, initially at least, will be protected from FATCA withholding tax (to the extent that withholding tax would otherwise arise).

DOCUMENTATION

A further point to make as regards the IRS's recent announcements is their impact upon market standard documentation for non-US syndicated loan transactions.

Market standard for these purposes usually means the FATCA-related riders that the Loan Market Association ("LMA") originally published last year, which provide for various means of imposing the risk of FATCA withholding tax on borrowers, agents and lenders.

As a slightly mundane point, the LMA has recently updated the common provisions in these riders to reflect the postponed first possible application date for FATCA withholding, i.e. 30th June 2014.

Of potentially more importance, however, the IRS's announcement of extended grandfathering from FATCA withholding impacts specifically upon "Rider 2" of the LMA's riders, which is premised upon the applicable facility agreement being initially grandfathered from FATCA withholding.

In this regard, Rider 2 imposes FATCA withholding tax risk on the lenders, but also enables them to veto modifications to the facility agreement if those modifications might sacrifice the expected grandfathering from that withholding tax and otherwise cause the withholding tax to apply to payments under the agreement. (The borrower can override this veto right in certain circumstances, it is worth noting.)

Originally, Rider 2 would have ceased to be relevant to facility agreements that were entered into after 31st December 2013, the previously scheduled date for grandfathering to cease. Under the IRS's proposals, however, the applicable grandfathering date will now be 30th June 2014, which obviously extends the potential application and relevance of Rider 2.

SUMMARY

FATCA has proven to be a thorny and contentious issue for participants in non-US syndicated loan markets.

In this regard, the IRS's recently published announcements do not radically change the regime's general application.

They do provide welcome postponements and other relaxations of that regime, however, as has been explained.

Moreover, given that these announcements are the latest in a series of FATCA-related modifications that the IRS have announced in recent years, one should not rule out further reform in the future.

Indeed, FATCA continues to be a moving target generally in terms of its scope and application - albeit one that is gradually becoming more acceptable to international financial markets.

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