The focus of this article is the set of tax provisions commonly found in a loan facility, between multiple lenders and a UK borrower, that follows the model promulgated by the Loan Market Association (the “LMA”). This is not, I fear, a subject to set pulses racing. But the LMA’s documentation is used very widely and these provisions (the “Tax Clause”) have some defects from the borrower’s perspective, which often go by default. An amended version of the Tax Clause is likely to appear soon and now seems a good time to draw attention to the more material points.

The LMA documentation was drafted (in the late 1990s) on behalf of bank participants in syndicated lending, so understandably it has never been entirely balanced. When it was first adopted, this mattered little from a tax perspective as the syndicate typically involved only UK banks or foreign banks lending through their London offices.

As that began to change attempts were made to mitigate the obvious borrower exposures, but these attempts have only been partially successful; indeed the problem was made worse a few years ago by a change to the assignment provisions, which extended the full protection of the Tax Clause to any lender introduced “in the ordinary course of primary syndication” even though that could (for example) include a lender for whom the borrower had to gross up interest payments from the outset.

WITHHOLDING TAX

The main purpose of the Tax Clause has always been to deal with the possibility that the borrower would have to withhold tax from its interest payments, under the rule now in section 874 Income Tax Act 2007.

Space does not allow me to consider the general statutory position here (nor the fearsome FATCA, which as things currently stand is likely to need particular attention if a borrower or guarantor is a “foreign financial institution” or may pay US source interest). I can though note two developments over the past year or so which are or might appear to be relevant.

The latter description applies to the election for exemption of foreign branch profits that was introduced by Finance Act 2011. Suffice to say that this should not be a concern for borrowers as the Tax Clause is currently drafted.

The relevant – and welcome – development is the Treaty Passport Scheme which came into effect in September 2010. Indeed the main change that can be expected to the Tax Clause is a new set of provisions catering for this scheme. Most (though not all) of the banks that are regular members of lending syndicates have by now acquired passports which in principle entitle them to receive interest free of withholding. They are not obliged to use them for any particular loan but it would be a little surprising if they did not typically do so.
This should greatly reduce the incidence of the most common tax-related problem for UK borrowers: an obligation to withhold tax, and then gross up the payment under the Tax Clause, simply because the procedural formalities are not completed in time.

The remaining difficulties from the borrower's perspective relate to the drafting of the Tax Clause.

“Treaty Lender”
In some treaties, the interest article applies only if the recipient will be taxed on the interest in its own jurisdiction. Until the treaty between Germany and the UK was updated last year, this meant for example that if a pension fund resident in Germany was a member of the syndicate, the UK borrower would inevitably have to withhold tax and the fund would be entitled to a gross-up under the Tax Clause.

This is so obviously unreasonable that nowadays lenders’ counsel are usually willing to accept the insertion of a further condition in the definition of Treaty Lender, along the following lines:

"meets all other conditions in the Treaty for full exemption from United Kingdom taxation on interest which relate to the Lender (including its tax or other status, the manner in which or the period for which it holds any rights under this Agreement, the reasons or purposes for its acquisition of such rights and the nature of any arrangements by which it disposes of or otherwise turns to account such rights)".

Tax credits
A second defect of the Tax Clause in this area is the provision which supposedly deals with the windfall that a taxpaying lender can expect to obtain if the borrower has to gross up a payment of interest, most often because there is insufficient time to obtain gross payment authority.

The tax credit provision appears to assume that the lender will receive any credit automatically and may find it difficult to identify the extent of the tax credit. In practice the problem is much more likely to arise in circumstances where the lender has a clear entitlement to an identifiable sum, irrespective of its own tax position, but must make a treaty claim to recover that sum from HMRC.

To deal with this, I suggest adding the following paragraph to this provision:

"If a Tax Deduction is required by law to be made from a payment made by a Borrower to a Treaty Lender but the Treaty Lender is entitled to a repayment or rebate of the relevant Tax (a "Treaty Rebate") by virtue of a relevant Treaty, the Treaty Lender shall promptly following the written request to do so from the Borrower claim that Treaty Rebate and shall within seven days of receiving any such Treaty Rebate pay to the Borrower a sum equal to the amount of the same."

Lender status
Finally, the Tax Clause offers no protection against the risk that the borrower pays interest gross because a lender has said it is a "Qualifying Lender", but that turns out not to be the case and the borrower is obliged to account for income tax in respect of a payment of interest already made.

The Tax Clause would ideally require reimbursement from the lender in such circumstances; clearly the lender is much better placed than anyone else to determine its own status. But there is a minimalist amendment which should provide a degree of comfort. In the “Tax Confirmation” given by original and any replacement lenders, the word “indicate” could be changed to “confirm” and the phrase "and for the benefit of the Agent and without any liability to any Obligor” should instead read “and for the benefit of the Agent and the Obligors".
TAX INDEMNITY

This provision has been a blot on the drafting of the Tax Clause since it first appeared. It purports to indemnify each lender against any tax which the lender determines, in its absolute discretion, “will be or has been (directly or indirectly) suffered for or on account of tax” in respect of the loan, other than tax imposed on the lender’s net income by its home jurisdiction or, if different, the jurisdiction from which it makes the loan.

This is absurdly wide, indeed cannot really mean what it appears to say: a lender could not expect to be indemnified merely because it claims that, as lender, it will indirectly suffer a cost on account of tax at some future date. But attempts to amend this aspect of the Tax Clause have always been rejected.

The borrower is advised to point to the main non-tax indemnity for comparison. This covers any “Increased Costs” that are actually incurred by a lender as a result of a change of law.

There is also a technical issue. The exception for tax on net income does not cover the scenario where a lender negotiates its participation from one branch outside its home jurisdiction but enters into the loan facility from another, which may lead to a tax charge on part of the interest income in the jurisdiction of the first branch.

As a matter of principle, the indemnity should in my view cover non-standard tax (that is, not tax on net income) incurred by a lender because of the borrower’s connection to the relevant jurisdiction or because of a change in law. Putting that together, I would suggest the following drafting as an amended version of the relevant provision in the Tax Clause:

“(a) The Company shall … pay to a Protected Party an amount equal to any loss, liability or cost suffered on account of Tax by that Protected Party in respect of a Finance Document which would not have been so suffered but for:

(i) a change after the date on which it became a Finance Party in (or in the interpretation, application or administration of) any law or Treaty or any published practice or concession of any relevant taxing authority; or

(ii) the incorporation or tax residence of a Borrower in the jurisdiction under the law of which the Tax is imposed.

(b) Paragraph (a) above shall not apply:

(i) with respect to any Tax assessed on a Finance Party:

(A) under the law of the jurisdiction in which that Finance Party is incorporated or, if different, the jurisdiction (or jurisdictions) in which that Finance Party is treated as resident or as having a permanent establishment for tax purposes; or

(B) under the law of the jurisdiction in which that Finance Party's Facility Office is located ......,

if that Tax is imposed on or calculated by reference to the net income received .... by that Finance Party.”

I would conclude by expressing the hope that, while others will I am sure prefer to deal in a different way with some or all of the points that I have highlighted, solutions of some kind will become a matter of routine and eventually the Tax Clause itself will be amended. The objective must be a set of provisions which barely need any tax input at all.

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