FATCA, IGAs and Loan Agreements – Some Good News At Last

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INTRODUCTION

On 12 September, the UK and the US signed the first Intergovernmental Agreement (“IGA”) relating to the implementation of FATCA, which follows very closely the provisions in the “Model I” IGA published in July by the US and five major European jurisdictions. There was more good news on 24 October when the IRS issued Announcement 2012-42 (available via http://www.irs.gov/pub/irs-drop/A-12-42.pdf), which pushes back FATCA withholding on gross proceeds from 2015 to 2017 and provides a generous grandfathering rule for obligations that create “foreign passthru payments” (see below).

Stephen Fiamma and Stefka Kavaldjieva discussed the UK/US IGA in an article published last month (‘FATCA IGAs alter the compliance landscape’ Tax Journal, dated 5 October). The article noted that the IGA seeks to resolve the concerns of “foreign financial institutions” (FFIs) that complying with FATCA might not be compatible with local laws on such matters as data protection and confidentiality. But it also concluded that the IGA does not provide a clear answer on FATCA withholding for gross proceeds and foreign passthru payments, and that there is unlikely to be any immediate impact on the documentation used for syndicated loans (or for other standard financing transactions such as bond issues and derivatives).

In our view this understates the effect and importance of the IGA. Indeed, we believe the answer has been provided: it is clear that FATCA withholding risk will be eliminated for FFIs in the UK and other jurisdictions that adopt the Model I IGA, except in cases of significant and sustained non-compliance. Consequently, we believe the FATCA riders for syndicated loan agreements issued in July by the Loan Market Association (LMA) have been superseded and a different approach is required.

THE WITHHOLDING PROBLEM EXPLAINED

Background

FATCA, as enacted in ss 1471-1474 of the Internal Revenue Code, encourages FFIs to enter into “FFI agreements” with the US government under which they agree to report information to the IRS about their US account holders. The intention is to allow the US to clamp down on tax evasion by US account holders. But the stick to ensure global compliance is the imposition of a new 30% withholding tax on three categories of payment. These can be summarised as:

- payments of US source income (from 1 January 2014);
- gross proceeds of disposal of an asset that produces US source interest or dividends (from 1 January 2017); and
- “foreign passthru payments” (foreign source payments originating from an FFI, to the extent
“attributable to” one of the first two categories – applicable from, at the earliest, 1 January 2017).

It is probably the last of these that has caused the most concern, because the payments do not need to have any direct connection with US source income. (Indeed, it remains unclear how this form of withholding would operate. The IRS has announced that the final FATCA regulations, expected to appear by the end of the year, will not address foreign passthru payments; it may be some years before rules on foreign passthru payments are issued.)

Loan agreements with US borrowers
In the absence of an IGA, FATCA would affect an FFI that is an agent for, party to or participant in a loan to a US borrower in three circumstances:

i. If it is a “non-participating FFI” (i.e. it does not enter into an FFI agreement), it would suffer FATCA withholding under s1471(a) on its receipt, as a beneficial owner or as an intermediary, of interest on the loan (from 1 January 2014) or gross proceeds of disposal of the loan (from 1 January 2017).

ii. If it enters into an FFI agreement, it would not suffer such withholding but would be obliged under the terms of the FFI agreement to withhold on interest and gross proceeds that it passes on to a non-participating FFI or (rarely in a syndicated loan) a “recalcitrant account holder”.

iii. Whether or not it has entered into an FFI agreement, it would be required under s1472 to withhold on interest and gross proceeds it passes on to certain foreign entities that are not FFIs (so-called “non-financial foreign entities” (NFFEs)) and that fail to comply with reporting requirements concerning their US owners. As a practical matter, s1472 withholding is rarely relevant for syndicated loans because the parties that receive payments under them will almost always be FFIs and not NFFEs.

Loans to US borrowers issued under agreements outstanding on 1 January 2013 are “grandfathered”, meaning that no payments under such loans will be subject to FATCA withholding regardless of when they are paid or received. Grandfathered status will be lost if the loan experiences a “material modification” on or after 1 January 2013.

Loan agreements with non-US borrowers
Where there is no US borrower, FATCA will in most cases be irrelevant.

If the non-US borrower is not an FFI, FATCA simply does not apply because payments by a non-US, non-FFI borrower neither have a US source nor are foreign passthru payments.

If the non-US borrower is an FFI (and there is no applicable IGA), FATCA could come into play, though only to the extent provided in future rules (if any) governing foreign passthru payments. It is noteworthy that Announcement 2012-42 extends grandfathering to obligations that could produce foreign passthru payments (assuming that they could not also produce US source income, or trigger gross proceeds withholding) which are outstanding as of the date that is six months after the date final foreign passthru rules are issued, so long as there are no “material modifications” after that date. But this grandfathering will be entirely academic for FFIs in jurisdictions that adopt the Model I IGA because, as is explained below, it will relieve such FFIs from suffering or administering FATCA withholding on all payments, including foreign passthru payments.

THE IGA’S SOLUTION

Under the UK/US IGA, any bank resident in the UK (but not its branches elsewhere), and any UK branch of a non-resident bank, will automatically be a “reporting financial institution” (RFI); it is not possible to opt out.

Loans to US borrowers
Article 4.1 of the UK/US IGA eliminates withholding concerns for UK RFIs that serve as agents, lenders or participants in loans to US borrowers. It states that a UK RFI which complies with its obligations under the IGA “shall be treated as complying with, and not subject to withholding under, s1471”.

02 SLAUGHTER AND MAY
This means that, without needing to enter into an FFI agreement, a compliant UK RFI will not be subject to FATCA withholding on interest or gross proceeds it receives from a US borrower. In addition, because the UK RFI will not enter into an FFI agreement, it will not be required to administer FATCA withholding on interest or gross proceeds it receives from a US borrower and passes on to non-participating FFIs. Instead, it merely needs to provide to the "immediate payor" (the borrower, or any paying agent for the borrower) sufficient information to allow the payor to withhold − a FATCA version of the procedure that already operates for ordinary US withholding.

(We should mention for completeness that an agent bank which is a "qualified intermediary" could be required to withhold under Article 4.1(d), but only if it has assumed primary withholding responsibility. As HMRC points out in paragraph 3.39 of the consultation document published on 18 September 2012, it is not expected that UK financial institutions will in practice come within this category.)

Loans to FFI borrowers
Similarly, Article 4.1 means that UK RFIs will not be required to suffer or administer FATCA withholding on foreign passthru payments, such as payments from FFI borrowers that are passed on by agent banks.

Article 6.2 of the IGA
Article 6.2 may have caused some confusion as to the effect of Article 4.1. It says this: "The Parties are committed to work together, along with other partners, to develop a practical and effective alternative approach to achieve the policy objectives of foreign passthrough payment and gross proceeds withholding that minimizes burden." In our view, this does not mean that withholding on foreign passthrough payments and gross proceeds is preserved pending agreement on an alternative. Article 4.1 has effectively eliminated withholding on foreign passthrough payments for UK financial institutions unless the UK agrees to its reintroduction – which seems inconceivable.

It is worth noting a broader point here. Since the enactment of FATCA in 2010, subsequent developments have reduced the scope of FATCA withholding, not increased it, and we expect any future changes to point in the same direction. Announcement 2012-42 is but the latest example of this trend.

Conclusion on Article 4.1 of the IGA
When the US and the five European jurisdictions announced the IGA alternative to FFI agreements in February 2012, they left an important question unanswered: would an FFI in a "partner country" (a country that signed an IGA with the US) be required to administer FATCA withholding under s1471 on payments it makes to an FFI in a "non-partner country"? Given that Article 4.1 eliminates FATCA withholding on payments made by a UK RFI to any other FFI, and that it is identical to language in the Model I IGA, we believe this issue has now been resolved.

Article 4.2 of the IGA – payments to NFFEs
This leaves the question (rarely relevant in the context of syndicated loan agreements, because of the status of most lenders) of withholding under section 1472 on interest and gross proceeds received from a US borrower and passed on by a UK RFI to a non-reporting NFFE. Here, the answer is provided by Article 4.2 of the IGA. The effect is that there will be no withholding under section 1472 on payments by a UK RFI to a non-reporting NFFE.

(We note in passing that Article 4.2 relieves UK RFIs from administering withholding under s1471 as well as s1472, and to this extent is redundant since Article 4.1 also relieves UK RFIs from administering withholding under s1471. We assume the reference to s1471 was included in Article 4.2 for the avoidance of doubt.)

GLOBAL SPREAD OF IGAS
To date only the UK has signed an IGA, and that IGA has not yet been ratified. But its operative provisions track those in the Model I IGA and it seems extremely likely that most major jurisdictions will sign this form of IGA. (Japan and Switzerland are negotiating an alternative form of IGA – a “Model II” IGA – but it would be surprising if this too did not eliminate withholding concerns for FFIs in those jurisdictions.)
FATCA PROVISIONS IN LOAN AGREEMENTS

LMA facilities
The FATCA legislation is complex and, understandably, provoked concerns from borrowers and lenders about how the withholding risk should be allocated in loan agreements. Borrowers worried because exemption from FATCA withholding depends on compliance and information reporting performed by FFIs over which the borrowers have no control. Lenders worried about the cost and effort required to comply with FATCA in order to avoid withholding, and had legitimate concerns about their ability to comply without breaching confidentiality and data protection rules in their jurisdictions. Lenders also feared that “foot-faults” – slight, unintentional compliance errors – might expose them to significant FATCA withholding risks.

On 18 July 2012 – just before the publication of the Model I IGA, as it turned out – the LMA published riders suggesting two ways of dealing with FATCA in loan agreements. Unfortunately, both sets of riders create significant commercial issues, and not only for the borrower.

The first set requires a gross-up and an indemnity from the borrower for FATCA taxes. This clearly puts the risk in the wrong place, as it is outside the borrower’s control. The approach is also unpopular with some lenders – US banks, in particular – that do not want borrowers to have to make additional payments to lenders that do not comply with FATCA.

The second set of riders is intended to ensure that a grandfathered loan does not lose that status by reason of a “material modification” to the terms of the loan after the relevant grandfathering date. But this raises real commercial concerns. The borrower either has to accept that every lender has a veto over changes to the loan (and over the introduction of additional borrowers or guarantors), or it must risk having to prepay lenders that are worried about FATCA risk.

Happily, a solution is now apparent. As we have noted, Article 4.1 of the UK/US IGA eliminates the FATCA withholding risk for all UK RFIs on loans to both US borrowers and non-US borrowers. The only exception is for UK RFIs that have failed to remedy “significant” non-compliance after notice and an eighteen-month cure period; foot-faults will not be penalised. Moreover, FFIs should have many “safe” jurisdictions to lend from in addition to the UK since it is clear that IGAs will be in place in most major jurisdictions some time before FATCA withholding begins on 1 January 2014.

There is no longer a reason for LMA-based loan agreements to place the FATCA risk arising from a lender’s non-compliance on any party other than the non-compliant lender.

LSTA facilities
Most loans in the US market are based on the “model credit agreement provisions” of the Loan Syndications and Trading Association (LSTA). While each agent bank in the US syndicated loan market has its own form of loan agreement, the LSTA model generally serves as the market standard, and this is certainly true for the clauses governing withholding taxes, gross-ups and indemnities.

The LSTA model places FATCA risk on lenders, not borrowers. It does this through two definitions: “excluded taxes” and “FATCA.” “Excluded taxes,” which are not grossed-up or indemnified, include “any US federal withholding Taxes imposed under FATCA,” including (generally) amended or successor versions of FATCA.

The LSTA model reflects the judgment of US market participants that lenders should bear the cost of FATCA’s withholding taxes because only the lenders can comply with FATCA’s reporting requirements and thereby eliminate the risk of FATCA withholding tax. The LSTA released its FATCA approach in August 2011, and since then that approach has become the clear standard in the US loan market.

WHERE DOES THIS LEAVE US?

The UK/US IGA will eliminate FATCA withholding for UK RFIs on loans to any borrower, whether US or
non-US. It should also provide real comfort to FFIs in other major jurisdictions that the threat of FATCA withholding will be lifted as more IGAs are signed. For such FFIs, withholding will apply only if they are non-compliant to a significant extent and on a sustained basis.

The international markets for bonds and swaps, and the US market for loans, accepted some time ago that FATCA risk should be borne by the party best placed to ensure it does not arise. It is now appropriate – and safe – for the European loan market to follow suit.

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