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FATCA: An Update From a European Loan Market Perspective

As set out in our *Client Alert* dated 14 February 2012 (*IRS Releases Proposed FATCA Regulations)*, the IRS released proposed regulations providing guidance for the implementation of the Foreign Account Tax Compliance Act ("**FATCA**") earlier this year. Under the proposed regulations, the impact of FATCA was effectively "grandfathered" to 1 January 2013, meaning that FATCA would not impact loans entered into prior to year-end, where such loans were not subsequently "materially modified". Our *Client Alert* contains further details on the highlights of the proposed regulations, including the effective dates for withholding and information reporting. The IRS and US Treasury Department expect to release final FATCA regulations during the autumn of 2012, but in the interim there have been some key developments regarding bilateral FATCA agreements between the US and other jurisdictions. Concerns had been expressed that FATCA had too broad an extraterritorial effect, with significant compliance costs and withholding tax risks imposed even where there is no US connection to the transaction in question. Furthermore, the required disclosure of account holders' details was believed to be contrary to many local laws applicable to those international institutions subject to FATCA. We take a further look at recent developments and their impact on the current state of options available to borrowers and lenders trying to resolve for the uncertainties of dealing with FATCA in the European market.

"The lack of any consistent approach towards FATCA related provisions means the European market is still faced with uncertainty as to the balance of FATCA risk between the borrowers and the lenders."

On 26 July 2012, the US Treasury released a model intergovernmental agreement designed to implement FATCA and government to government information sharing[1]. The model agreement was developed in consultation with France, Germany, Italy, Spain and the United Kingdom (the "**EU FATCA Partners**") and two versions were released: a reciprocal version and a non-reciprocal version. The US Treasury also released a joint communique with the EU FATCA Partners endorsing the agreement and calling for a speedy conclusion of bilateral agreements based on the model agreement, including by other jurisdictions. Following on from this joint communique, on 12 September 2012, the UK government signed an agreement with the United States to improve international tax compliance and to implement FATCA. The UK-US agreement[2] is based on the model intergovernmental agreement and aims to address the legal barriers to complying with FATCA and to simplify the implementation of FATCA for financial institutions.

Broadly speaking, the model agreement sets out a framework within which foreign financial institutions ("**FFIs**") resident in or branches of a FFI located in a country that has signed the model agreement (a "**FATCA Partner**") will not need to enter into a separate FATCA agreement with the IRS and will not be subject to FATCA withholding tax on payments made to them. These FFIs will instead be required to collect and report information required by FATCA to the tax authorities in a FATCA Partner, who will then provide this information to the IRS. Doing this, the FFIs in the FATCA Partners will be deemed "FATCA Compliant". Further, FFIs in a FATCA Partner will be deemed compliant notwithstanding that such FFIs have non-compliant affiliates or branches (as a result of local law prohibitions) so long as such affiliates or branches comply with certain limited restrictions.

The model agreement does not entirely address the approach to foreign passthru payments and gross proceeds withholding. Instead it makes a commitment to developing "a practical and effective alternative approach to achieve the policy objectives of foreign passthru payments and gross proceeds withholding that minimises the burden". The reciprocal version of the model agreement also provides for the US to exchange information currently collected on accounts held in US financial institutions by residents of FATCA Partners and was drafted to be used only in countries with which the US has an income tax treaty or information exchange agreement and for which the Treasury and the IRS have determined the government has sufficient protections to ensure the information is kept confidential and is used only for tax purposes.

US Market Position

The treatment of FATCA under US syndicated loans has become a market standard relatively quickly, with the LSTA Model Credit Agreement Provisions providing that the interest gross up applies to "Indemnified Taxes" which include taxes imposed on or with respect to any payment made by the borrower under loan documents, other than "Excluded Taxes" (which include any US federal withholding taxes imposed under FATCA). A FATCA withholding on interest payments is therefore at the risk of the lenders, and not subject to a gross up.

European Market Position

This is one element of US loan market practice which is not being reflected in any consistent manner across Europe, even by US banks which have agreed the US market position on a US syndicated loan. The concern in Europe with the US negotiated position is that a number of European financial institutions may not be able to comply with the requirement to enter into a "FFI Agreement" because of European data privacy laws, and more generally may take the view that it is entirely consistent with market standards for this risk to be placed upon the borrower. The uncertainties as to the reaction of potential syndicate members to a "lender risk" FATCA provision is such that mandated lead arrangers are keen to preserve the existing position typically enshrined in tax gross up clauses rather than embark upon a new market provision. If the requirement to enter into a FFI Agreement is waived for FFIs resident in, or operating through a branch in, FATCA Partner jurisdictions, then it may be logical to retain the European norm for gross up risks to remain a borrower risk.

Nonetheless, a number of different variations have been seen in the market:

LMA Position

In July 2012 the LMA published various riders in response to the FATCA withholding tax issues. However, these are more intended to assist in the development of market standards, and are "possible approaches which should be considered on a deal-by-deal basis, in the light of the factual background and the commercial deal". It is important to note that the FATCA regulations remain in draft and the riders are based on a view of how FATCA is likely to apply. Additionally, the LMA riders also assume that "grandfathering" will apply, and so should not be used for any loans where there is doubt that this is the case (or any loan entered into on or after 1 January 2013). It should also be noted that the riders are drafted for the LMA investment grade facility, and so other changes may be required for the leveraged lending precedent.

The two LMA options catered for in the riders provide for:

- Borrower risk – this may be appropriate where the borrower can prevent there being any FFI borrower or US borrower[3] involved in the financing and/or controls the facility so that there are no material modifications of the facility agreement. Whilst it can be anticipated that this approach might work for non-US investment grade credits, where for operational or tax reasons the use of a US borrower is not required, it is submitted that it will be increasingly difficult to apply this option to leveraged loans for various reasons, not least that sponsors will attempt to force banks to agree to the US position. Firstly, it is much more likely that for deal structuring and tax efficiency reasons (or the ability to access the US loan markets investor base) a US borrower is required. Second, the "grandfathering" provisions may not give comfort if one anticipates a "worst case" scenario (ie. that the loan goes into a restructuring which constitutes a "material modification" thus losing the benefit of the grandfathering provision).
- Lender risk – the LMA riders contain a US style "lender risk" option but bearing in mind the riders are only proposed to be used during the grandfathering period it is suspected that this option would only be acceptable where lenders are willing to take a view that there is little chance of the FATCA issue resulting in a tax deduction on interest. This risk is mitigated further by providing that lenders have a right to veto any amendment that might result in a loss of grandfathering, unless the borrower designates the lender as a "FATCA Protected Lender", which then means that if a withholding due to FATCA arises on a payment to that lender, the borrower is required to either prepay or replace the lender concerned. A further optional provision has been included which limits the scope of lenders which may be prepaid in this way (eg. to holders in primary syndication only or to those lenders which cannot comply with FATCA due to prohibitions in the countries in which they operate).

The other LMA related provisions include information sharing provisions facilitating FATCA compliance by agents and others and provisions enabling the Agent to be replaced if it becomes non-compliant with FATCA.

No FATCA Specific Language

A number of financings recently have addressed FATCA during the course of negotiation, but it was concluded that the issue would not be addressed specifically so the customary obligation to gross up (with various exceptions) will apply. As described above, the grandfathering will indeed protect the borrower against grossing up, unless there is a subsequent material modification. If there is such a material modification, then the grandfathering would no longer apply. The implication of not dealing with FATCA expressly will depend on the overall drafting of the tax provisions, but some formulations of the clause will require lenders to complete such administrative formalities as are necessary to have interest paid gross, which could therefore include non-compliance with FATCA through the back door (noting that the implementation of the intergovernmental agreements would significantly reduce this risk).

FATCA — Compliant Lenders

We have seen provisions in revolving credit facilities for European borrowers which provide that there is only a FATCA gross up to any lender if the borrower makes a drawing after it has been notified by such lender that it is FATCA non-compliant. Clearly this mechanism would not work for term loans.

FATCA Gross Up Applicable to Loans Syndicated to the European Market Only

Some credit agreements have taken the approach that because US investors understand FATCA risk, then, for example, a USD term B loan syndicated to US investors will not get the benefit of a gross up for FATCA non-compliance, whereas the lenders to the portion of the loan syndicated to the European market will get that gross up.

No Greater Certainty?

The lack of any consistent approach towards FATCA related provisions means the European market is still faced with uncertainty as to the balance of FATCA risk between the borrowers and the lenders. Further, the fact that the LMA riders set out options to cover for both approaches is determinate that there is no conclusion as to expectation of how risk should be allocated. It should also be noted that much of the FATCA legislation remains in draft form and the LMA anticipates that it will issue further guidance and drafting when the final legislation is released before the end of this year. As further developments arise in this area, it will be interesting to see whether the UK-US agreement will offer any comfort with regard to easing the practicalities of complying with FATCA and whether such compliance will impact any change in attitude towards the allocation of FATCA withholding risk.

Endnotes

[1] The US Treasury is expected to release a second model intergovernmental agreement in consultation with Japan and Switzerland in the near future (the US Treasury issued a joint statement with Japan and Switzerland on 21 June 2012 outlining a new framework for FFIs in those countries to comply with FATCA).

[2] This agreement is not yet in force. It has been laid before the Houses of Parliament and will undergo a 21 sitting day scrutiny period as part of the ratification process. Financial institutions and other interested parties will now be consulted on the implementation of the agreement in the UK and draft legislation is expected to be published later in 2012.

[3] It should be noted that a borrower's payment could have a US source even if it is not incorporated or if it is not tax resident in the US. For example, a FATCA deduction may be imposed on payments from a non-US borrower that is engaged in a US trade or business.

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