The LSTA Model Credit Agreement: Overview of Tax Changes

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Introduction

The Loan Syndications and Trading Association ("LSTA") is an organization devoted to promoting a fair and orderly corporate loan market and advancing and balancing the interests of all market participants. On August 10, 2011, the LSTA released new tax provisions for its Model Credit Agreement Provisions (the "LSTA Model"). The tax provisions had not been updated since 2005, and the changes are designed to ensure that the LSTA Model reflects current market practice as far as possible.[1] The new provisions are significant for both a U.S. borrower and non-U.S. lenders that are parties to a loan agreement.

This article summarizes the tax provisions of the LSTA Model and then discusses two changes that merit special attention: provisions reflecting the 2010 enactment of the U.S. Foreign Account Tax Compliance Act ("FATCA");[2] and changes to the "increased costs" clause to reflect new taxes being considered in the wake of the global financial crisis.

Basic Withholding Tax Provisions

The United States imposes a 30% withholding tax on interest paid by a U.S. borrower to a non-U.S. lender, subject to certain statutory and treaty exemptions. Normally the lender agrees to bear withholding taxes imposed at the time the lender acquires its interest in the loan ("Day 1 withholding taxes"), and the borrower bears withholding taxes arising from changes in law thereafter.

The arrangement reflects the fact that lenders can most easily structure their loans to qualify for an exemption from Day 1 withholding tax, not lend at all, or make the loan knowing that they will bear the Day 1 withholding tax. However, lenders cannot structure for withholding taxes that may result from future changes in law and would have to charge higher interest rates if forced to bear this risk. Therefore, borrowers accept the change-in-law risk.

The LSTA Model reflects this arrangement. The borrower is entitled to withhold any withholding taxes and pay them to the applicable taxing authority.[3] "Excluded Taxes", which are taxes that are not grossed-up, include Day 1 withholding taxes. "Indemnified Taxes", which are grossed-up, include all taxes, other than Excluded Taxes, imposed on payments and therefore include taxes arising from a change in law.[4] As a backstop to the gross-up obligation, the borrower also must indemnify a lender for any Indemnified Taxes the lender pays directly to a taxing authority.[5]

1 - See the LSTA web site at <www.lsta.org> and the announcement of the new provisions at <www.lsta.org/content.aspx?id=14022>.
2 - Hiring Incentives to Restore Employment Act § 501, Pub. L. No. 111-147.
3 - LSTA Model, Yield Protection § 2(a).

FATCA Provisions

FATCA added Sections 1471 through 1474 to the U.S. Internal Revenue Code. Those sections impose a separate 30% withholding tax on certain payments to foreign financial institutions ("FFIs"), including interest paid by a U.S. borrower, if the FFI does not agree to disclose information about its U.S. accountholders to the U.S. government. Under the statute, withholding begins on January 1, 2013, but does not apply to loans made pursuant to agreements entered into on or before March 18, 2012. Recent guidance by the IRS in Notice 2011-53 defers withholding until January 1, 2014, but at that time withholding will begin for loans made pursuant to agreements entered into after March 18, 2012.

The LSTA Model reflects the view that lenders should bear the FATCA risk. Accordingly, it adds, as Excluded Taxes, "U.S. federal withholding Taxes imposed under FATCA". As a result, if FATCA were defined as the version of FATCA enacted in 2010, then Indemnified Taxes (which are borne by the borrower) would automatically include all withholding taxes arising from any future amendments to FATCA to expand the disclosure obligations of FFIs.

However, FATCA imposes withholding because of the failure of an FFI lender to make disclosures to the U.S. government. Consequently, FATCA taxes are uniquely within a lender's control, unlike other taxes resulting from a change in law. Borrowers therefore have sought to expand the definition of "FATCA" to include amendments after a loan is made. The LSTA Model reflects this approach:

> *"FATCA" means Sections 1471 through 1474 of the Code, as of the date of this Agreement (or any amended or successor version that is substantively comparable and not materially more onerous to comply with) and any current or future regulations or official interpretations thereof.*[6]

As a result, FATCA withholding taxes remain Excluded Taxes as long as FATCA requires lenders to disclose information to the U.S. government that is comparable to the information required today. However, if amendments to FATCA significantly increase the information required from an FFI, disputes might arise as to whether compliance is "materially more onerous" for the FFI to comply with, and whether the FFI could then refuse to comply, become subject to withholding tax, and require a gross-up from the borrower.

The LSTA Model does not require lenders to comply with FATCA's reporting obligations. Rather, it merely requires lenders to inform the borrower and administrative agent whether they have complied with FATCA so that proper withholdings can be made.[7]

4 - LSTA Model, Yield Protection § 2(a). For example, on a $100 interest payment subject to a 30% withholding tax, if the withholding tax is a Day 1 withholding tax, the borrower withholds $30 and pays $70 to the lender. If the withholding tax is not a Day 1 withholding tax, the borrower "grosses-up" the lender so that the lender receives $100 net of withholding. The borrower pays $42.86 to the taxing authority, so that the withholding tax of $42.86 equals 30% of the borrower's total payment of $142.86.
5 - LSTA Model, Yield Protection § 2(d).
6 - LSTA Model, Definitions (emphasis added).
7 - LSTA Model, Yield Protection § 2(g)(ii)(B)(iv).

Increased Costs

Loan agreements generally require the borrower to indemnify lenders for changes in law[8] that increase lending costs.[9] The application of these clauses to taxes has often been a point of contention. Borrowers argue that taxes should be addressed only in the "tax section" (i.e., Yield Protection § 2). Lenders argue that the tax section deals only with taxes on payments under the loan and is insufficient to provide yield protection for taxes that are not imposed on loan payments. The 2005 version of the LSTA Model included an ambiguous tax clause for increased costs.

The new LSTA Model requires the borrower to indemnify lenders for costs resulting from change-in-law taxes on the lenders' "loans, loan principal, letters of credit, commitments, or other obligations, or its deposits, reserves, other liabilities or capital attributable thereto".[10] The new clause carves out Excluded Taxes and Indemnified Taxes (both of which are covered in the tax section). It also carves out "Connection Income Taxes", which essentially means any income taxes imposed by a jurisdiction in which the lender is organized or has a lending office.
Recent examples of taxes that would be covered under this new clause—if they were not enacted as of the date the loan agreement was entered into—include the global bank tax considered (but presently not included) in Basel III,[11] the recently-enacted bank tax in the United Kingdom[12] and the Obama administration's proposed "financial crisis responsibility fee".[13]

Conclusion

Based on our experience, we believe the 2011 LSTA Model reflects current market practice and recent developments arising out of the financial crisis. Time will tell whether the LSTA achieved its goal of creating a set of tax provisions acceptable to most borrowers and lenders in typical loan agreements.

8 - Costs existing when the loan is made are priced into the interest rate.
9 - These provisions apply only to loans based on the LIBO rate. By contrast, so-called base rate loans pass any increased costs directly to the borrower in the form of a higher interest rate.
10 - LSTA Model, Yield Protection § 1(a).
11 - See Basel Committee, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems (Dec. 2010), available at <www.bis.org/publ/bcbs189.pdf>.
12 - Finance Act (no. 3), 2010-11, Schedule 19 (Eng.).
13 - Budget of the United States Government, Fiscal Year 2012 (2011), description available at <www.jct.gov/publications.html?func=startdown&id=3796> at *131.

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