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Withholding tax issues on Facility Agreements: traps for the unwary

Introduction

The basic position on withholding taxes in facility agreements based on the Loan Market Association's standard documentation is quite simple. A borrower only withholds taxes on interest payments made to the lender to the extent required by law and has to gross the lender up if a tax is withheld, subject to one key exception.

This exception applies, and so the borrower has no obligation to gross up, where the lender is not or ceases to be a so-called "Qualifying Lender", unless the absence of Qualifying Lender status is as a consequence of a change of law. With this in mind, from the borrower's perspective the definition of "Qualifying Lender" is obviously a critical factor. Broadly speaking, market practice is that the definition of "Qualifying Lender" should be such that, based on the law at the date of the agreement, no withholding tax is due on interest paid to such lender (either because of a domestic or EU exemption or application of a double tax treaty). The intended result is that if there is no change of law no withholding tax should arise and the borrower will not be required to make gross up payments.

Accordingly, it can be tempting for borrowers, when negotiating tax clauses in facility agreements, to simply focus on ensuring that "standard LMA" Qualifying Lender provisions are in place – assuming that if this is done the commercial position will be as described above in all circumstances. However, this briefing highlights certain areas where this might not be enough to protect the borrower's position, particularly in light of recent developments.

1. Don't forget to file your paperwork! Procedural requirements

Borrowers need to be satisfied that all conditions for relief from withholding tax, either under domestic or EU law or under the relevant double tax treaty, have been satisfied. In some situations, a borrower may not be authorised to pay interest to a Qualifying Lender free of withholding tax until certain procedural requirements have been complied with.

These procedural requirements vary between jurisdictions and may include:

- the provision by the lender of a certificate (supplied by the relevant tax authority) confirming the lender's tax residence;
- provision of forms, representations or certificates of beneficial ownership and status by the lender to the borrower; and/or
- formal confirmation to the borrower from the relevant tax authority that the lender is entitled to receive payments from that jurisdiction without withholding tax (which may require action to be taken by the lender and/or the borrower).

Such procedural formalities may seem like technicalities and not points for negotiation in the facility agreement. However, the importance of (i) allocating who will take the risk of such steps not being completed by the relevant interest payment date; and (ii) making sure they are satisfied in practice, should not be underestimated. Failure to do so could mean not only that the interest payment could be subject to withholding but, as the lender may still (depending on the drafting) technically be a Qualifying Lender, the borrower would be required to gross up.

2. Impending change in law – The Unshell Directive

The European Commission has published a proposal to prevent the misuse of shell entities for tax evasion and tax avoidance purposes (the ***Unshell Directive***) and it appears likely that this will be adopted in some form this year, with effect from 1 January 2024, so it is important to be aware of its potential impact.

Under the Unshell Directive, entities that are tax resident in the European Union with limited substance (in terms of scope of activities, number of employees, physical infrastructure, etc.) may be treated as a "shell entity".

As currently proposed, a shell entity would lose its right to tax treaty benefits and certain tax exemptions provided for under EU law, such as under the Interest and Royalties Directive, and therefore interest payments made to it could be subject to withholding tax.

In the context of facility agreements, the classification of a lender as a "shell entity" under these rules may mean that it ceases to be a Qualifying Lender (as it is no longer entitled to the benefits of a tax treaty or EU exemption). As this loss of Qualifying Lender status would be as a result of a "change in law", the standard risk allocation described above would mean that it is the *borrower* that assumes the risk of the lender being treated as a shell entity under these rules, and, as such, the borrower would be required to gross up payments to the shell entity.

Borrowers wishing to ensure that the lender bears the risk of its own vehicle being classified as a shell entity should consider seeking protection from this type of situation by carving this scenario out of the "change in law" provision in the LMA.

Under the current proposals, traditional bank lenders are likely to be excluded from the scope of the Unshell Directive. However, alternative finance providers such as SPVs, funds or financial holding entities could still be in scope and, to the extent that the facility agreement can be assigned or transferred from traditional lending entities to other types of lender, or held by such lenders from the start, then this change in law protection should be considered.

3. Who is the beneficial owner of the interest payments?

To benefit from a withholding tax exemption (or a reduced withholding tax rate) under tax treaties or the Interest and Royalties Directive, a lender typically has to be the "beneficial owner" of the interest payments. The current climate has led to a sharper focus from tax authorities on who the beneficial owner of the interest is and "beneficial ownership" being interpreted by both the courts and tax authorities as having a meaning going beyond the traditional legal meaning, drawing in anti-avoidance concepts.

The ECJ decisions in the "Danish Cases" have had a significant impact in this area. These cases involved non-EU investment funds that granted loans to Luxembourg vehicles, which, in turn, granted loans to a Danish company. The Danish company paid interest to the Luxembourg company free of withholding tax under the Interest and Royalties Directive. This was challenged by the Danish tax authorities on the basis that the Luxembourg company was not the beneficial owner of the interest and the actual beneficial owners were not entitled to the withholding tax exemption (as they were not resident in the EU).

The ECJ confirmed that Member States can deny the application of the withholding tax exemption if the recipient of the interest is not the beneficial owner. In determining the beneficial owner, the ECJ found that it is necessary to consider economic interest, control and also set out certain indicators of abuse that may lead to denial of relief under the Directive. Following the Danish Cases, there has been a noticeable shift by tax authorities and courts in the EU and evidence they are taking a stricter approach to beneficial ownership, with the principles set forth by the ECJ in the Danish Cases being used to deny relief more frequently.

Borrowers should carefully consider whether a lender's structure might mean that its ability to rely on a tax treaty, domestic or EU exemption could be challenged by a tax authority on the basis of the beneficial ownership requirement. What confirmations from the lenders does the borrower require under its domestic law in order to be able to pay without withholding? What will the borrower's position be under domestic law if it wrongly pays without withholding (including based on incorrect confirmations from the lender) – and if this happens, what will its position be vis a vis the lender under the facility agreement? What happens if there is a sub-participation of a facility transferring beneficial ownership from the lender of record to the sub-participant? These points are often not clearly dealt with if using "LMA standard" provisions.

4. Issues created by the Borrower's group structure

Withholding tax exemption challenges can also be relevant in the context of borrower group financing structures where the third party financing is provided to a holding company with limited activity and subsequently pushed down through intragroup loans to another entity in the borrower's group located in a different jurisdiction (e.g., a parent located in country A borrowing externally and lending to a subsidiary located in country B). The use of this type of double-tier structure is sometimes stipulated by third party lenders for non-tax reasons.

However, standard LMA tax clauses would not protect the borrower in such cases from the risk that, following the Danish Cases and increased scrutiny by tax authorities across Europe, the borrower in country A could potentially now suffer withholding tax on the interest paid to it by its subsidiary in country B, but still be required, under standard LMA provisions, to pay interest free of withholding to the ultimate lending entities, with the corresponding cash leakage. An additional risk is that the interest paid by the holding company (in country A) on the external loans may be deemed to be sourced from the underlying borrower jurisdiction (country B), resulting in the holding company having to withhold country B tax from payments it makes to external lenders.

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Points to consider in this situation include whether lenders should be restricted to those who will be treated as a Qualifying Lender in both country A and country B and/or what information and documentation obligations should be put on lenders that might aid the borrower group in mitigating the cost of any withholding. These are points that require both technical analysis and thoughtful negotiation to address effectively.

If you have any questions about any of the issues raised in this briefing, please get in touch with any of your usual Freshfields contacts for further information on how best to protect yourself against these risks.

Jill Gatehouse

Partner, London
T +44 20 7716 4190
E jill.gatehouse@freshfields.com

María Mera

Counsel, Madrid
T +34 91 700 1795
E maria.mera@freshfields.com

Brin Rajathurai

Senior Knowledge Lawyer, London
T +44 20 7785 2161
E brin.rajathurai@freshfields.com

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