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Tax Aspects of Credit Agreements: The Lender's Perspective

This article discusses the basic framework and purpose of the tax provisions of a credit agreement, with a focus on the concerns particular to a lender in negotiating such provisions. The tax provisions can be an important part of negotiations, as they allocate the tax costs and risks related to the borrowing and repayment of the loan among the various parties, which will have a continuing effect on the parties well after the money has been disbursed to the borrower. The allocation of tax costs and risks can have a material impact on the lender's expected return on loans made pursuant to a credit agreement, as well as a significant effect on the collateral and other security for a loan. Lenders and their tax advisors should thoroughly understand the tax provisions in a credit agreement and take care to negotiate terms that will ensure that both their economic return and security support are protected.

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A credit agreement is the document a borrower and a lender sign wherein the lender agrees to lend funds to the borrower and the borrower agrees to repay such funds according to particular terms ("Credit Agreement"). It defines each party's rights and economic agenda. The basic framework and purpose of the tax provisions of a Credit Agreement are the foci of this article. In particular, the article discusses a lender's concerns in negotiating the tax provisions of a Credit Agreement. The tax provisions are important because they allocate both the tax costs and the risks related to the borrowing and repayment of the loan among the various parties. The allocation of the tax obligations under a Credit Agreement has a continuing effect on the parties well after the initial loan is made and the money is disbursed to the borrower.

Generally, a lender's objective in negotiating the terms of a Credit Agreement is to maximize its economic return from making the loan. The lender also wants to ensure that there is adequate security for the loan and that the borrower is able to repay the loan in accordance with the terms of the Credit Agreement. In other words, the lender does not want the terms of the Credit Agreement to be so restrictive or oppressive that the borrower is unable to meet its obligations thereunder. Additionally, a lender may intend to syndicate a loan after the Credit Agreement has been signed. If this is the case, the lender must ensure that the Credit Agreement's terms will be administrable if widely held, and that they will be attractive to other potential lenders as well.[1]

PARTIES TO A CREDIT AGREEMENT

A typical Credit Agreement has one or more lenders (each, a "Lender") and one or more borrowers (each, a "Borrower"). If there is more than one Borrower, the Borrowers will usually be related to each other, either as parent-subsidiary or as brother-sister entities with the same direct or indirect parent. If there are multiple Lenders, one Lender typically acts as administrative agent for the group of Lenders (the "Administrative Agent"). The Borrower will typically make all pay-

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[1] The Loan Syndications and Trading Association (LSTA) publishes sample provisions for syndicated credit agreements that can serve as useful guidelines in negotiating syndicated loans. For more information, see their website at http://www.lsta.org/.

ments under the Credit Agreement to the Administrative Agent, who then allocates and makes payments over to the other Lenders.

TAX PROVISIONS OF CREDIT AGREEMENTS

Allocation of Taxes on Payments. Generally, a Credit Agreement provides that payments made by a Borrower to a Lender under the terms of a Credit Agreement will be made without deduction or withholding for Taxes, unless required by law. A typical definition for "Taxes" will be broad, and will include any interest and penalties with respect to taxes, such as:

> "Taxes" means all taxes, charges, duties, fees, levies, or other like assessments, including any deductions or withholdings (including backup withholding) imposed by any Governmental Authority, and including any interest, penalty, or addition thereto.

If any Taxes are required to be deducted or withheld from any payment under the Credit Agreement, then it must be determined whether such Taxes are to be borne by the Borrower, in which case the payment to the Lender is increased to ensure the Lender receives the amount it would have received in the absence of such deduction or withholding (a "gross-up"), or by the Lender, in which case no gross-up will be provided by the Borrower. An example of a tax allocation provision is as follows:

The allocation of Taxes between the Borrower and the Lender is handled through the definition of the term "Indemnified Taxes" and what is typically a web of related definitions that must be closely parsed in order to determine which Taxes will be grossed-up by the Borrower and which will not.

> *Taxes*. Except to the extent required by applicable law, all payments by or on account of the Borrower under this Credit Agreement shall be made without deduction or withholding for any Taxes. If any deduction or withholding is required, such deduction or withholding shall be made, and all such Taxes shall be timely paid to the relevant Governmental Authority in accordance with applicable law. If such Tax is an Indemnified Tax, then the amount paid by the Borrower shall be increased so that the Lender receives an amount equal to the sum it would have received had no deduction or withholding for Indemnified Taxes been made (including any deduction and withholding applicable to any additional amounts payable by the Borrower under this paragraph).

Aside from allocating the Taxes between the Borrower and the Lender by virtue of the gross-up for Indemnified Taxes, the sample provision above provides several other benefits to a Lender. First, it requires that all Taxes deducted and withheld be paid over to the applicable governmental authority, whether it is an Indemnified Tax or not. Second, it provides a gross-up for Indemnified Taxes on gross-up payments as well. Thus, if any Indemnified Taxes are withheld, the Borrower must increase its payments to compensate not only for the amount of the Indemnified Taxes, but also for any Indemnified Taxes payable with respect to such additional amounts.

If there is an Administrative Agent, the Administrative Agent will likely be a withholding agent under U.S. federal income tax law if it is making payments over to the other Lenders.[2] As a result, the Administrative Agent may want to ensure that it is able to make its own determination of whether withholding is required with respect to payments under the Credit Agreement, rather than being bound to the Borrower's determination. If the Administrative Agent makes its own determination, the Lenders will want the Borrower to be required to gross-up its payments on the basis of the Administrative Agent's determination.

Tax Allocation Definitions. The *Taxes* provision, discussed above, generally provides that the Borrower will gross-up the Lender for Indemnified Taxes that must be withheld from payments under the Credit Agreement. Thus, the allocation of Taxes between the Borrower and the Lender is handled through the definition of the term "Indemnified Taxes" and what is typically a web of related definitions that must be closely parsed in order to determine which Taxes will be grossed-up by the Borrower and which will not.

Generally, Indemnified Taxes include all Taxes imposed on or paid with respect to payments under the Credit Agreement, other than those that are explicitly excluded ("Excluded Taxes"). The Borrower typically also pays stamp, documentary, and other similar taxes resulting from the Credit Agreement ("Other Taxes"), although there is frequently an exclusion for Other Taxes that arise as a result of a sale or assignment under the Credit Agreement by the Lender. This could occur if the Lender either transfers its rights under the Credit Agreement to a third party or changes the location of the arrangement within its group of related entities. If any provision in the

[2] See, e.g., IRC §§ 1442, 1441(a), and 7701(a)(16).

Credit Agreement allows the Borrower to request or require the Lender to assign its interest in the Credit Agreement (for example, because an Indemnified Tax or other charge borne by the Borrower could be mitigated through an assignment), the Lender will want to ensure that any Other Taxes resulting from an assignment requested by the Borrower will be paid by the Borrower. Other Taxes are generally included in the definition of Indemnified Taxes, which pulls them into the general Tax allocation and indemnification provisions, but they are sometimes handled through stand-alone provisions for Other Taxes.

The heart of the allocation of Taxes between the Borrower and the Lender is the definition of Excluded Taxes—i.e., the Taxes related to or arising as a result of the Credit Agreement that will not be indemnified or grossed-up by the Borrower. The purpose of the definition is generally to ensure that the Borrower does not bear (1) Taxes the Lender owes with respect to its business-related activities, such as income and branch profit taxes, or (2) Taxes that are triggered by the Lender's action or inaction, such as those under the Foreign Account Tax Compliance Act (FATCA) or incurred as a result of the Lender not providing the required documentation with respect to withholding Taxes. This definition can also be used to delineate the business deal with respect to withholding Taxes and to allocate the risk for unknown Taxes and changes in tax law. A prudent Lender will push for a narrow and specific definition of Excluded Taxes so that the Borrower bears the risk for unknown Taxes and changes in tax law, which will help ensure that the Lender will preserve its expected return on the loan.

An example definition for Excluded Taxes, reflecting the typical framework for such provision, is:

> "Excluded Taxes" means any of the following Taxes imposed on or with respect to a recipient of a payment under the Credit Agreement: (a) income Taxes, franchise Taxes and branch profits Taxes, in each case, imposed as a result of (i) the recipient being organized under the laws of, or having its principal office or applicable lending office located in, the jurisdiction imposing such Tax or (ii) another connection between the recipient and the jurisdiction imposing such Tax (other than connections arising from the recipient having executed, delivered, become a party to, performed its obligations under, received payments under, received or perfected a security interest under, engaged in any other transaction pursuant to or enforced the Credit Agreement or any related document, or sold or assigned an interest in any Loan, the Credit Agreement or any related document); (b) withholding Taxes imposed pursuant to a law in effect on the date on which the recipient acquired its interest in the Loan (other than pursuant to an assignment request by the Borrower) or changes its lending office, except in each case, to the extent that amounts with respect to such Taxes were payable either to such recipient or its assignor immediately before the recipient became a party hereto or changed its lending office; (c) Taxes attributable to such recipient's failure to comply with [Withholding Documentation Requirements, discussed below]; and (d) any U.S. federal withholding Taxes imposed under FATCA.

Supporting Allocation Provisions. The sample *Taxes* provision discussed above handles Taxes that are withheld or deducted from payments under the Credit Agreement. Other provisions are necessary to provide for the payment and reimbursement of Indemnified Taxes that are not withheld or deducted from payments made by the Borrower. For instance, a provision should be included to provide that the Borrower will indemnify the Lender for any Indemnified Taxes paid by the Lender, including any such amounts that are owed with respect to any Indemnified Taxes paid by the Borrower (similar to the gross-up on the gross-up discussed above). Particularly when there is an Administrative Agent that is acting as a withholding agent, this provision should also require indemnification for Taxes that are withheld, in case the Administrative Agent determines withholding applies when the Borrower has not grossed-up the payment. This provision can also contain language requiring the Borrower to reimburse the Lender for expenses, and language that protects the Lender from the Borrower's refusal to pay on the basis that it does not believe a Tax was properly imposed. For example, such provision could provide:

> *Indemnification by Borrower*. The Borrower shall indemnify the Lender for the full amount of any Indemnified Taxes (including Indemnified Taxes imposed on or attributable to amounts payable under this Section) payable or paid by the Lender or required to be withheld or deducted from a payment to the Lender and any reasonable expenses arising therefrom or with respect thereto, whether or not such Indemnified Taxes were properly imposed or asserted by the relevant Governmental Authority. A certificate as to the amount of such payment or liability delivered by the Lender shall be conclusive absent manifest error.

In addition, particularly when Other Taxes are not included in the definition of Indemnified Taxes (and as such not covered by the above provision), a separate section should be included stating that the Borrower will timely pay Other Taxes and reimburse the Lender for any Other Taxes paid or payable by the Lender. This provision should include the same protections with respect to expenses and the conclusiveness of amounts imposed. It also benefits a Lender to request that the Borrower provide it with evidence of any payments of Taxes by the Borrower. A survival provision should also be included, which ensures that the Lender's right to indemnification for Taxes survives its replacement as a Lender, the termination of the loan, or the repayments of all of the loans by the Borrower.

The Borrower will typically request that, should a Lender receive a refund of Taxes that the Borrower either paid or indemnified the Lender for, the Lender will pay over such refund to the Borrower. While this generally is a reasonable request, in negotiating the refund provision, the Lender should consider building in certain protections. For instance, the Lender will likely want sole control over the determination of whether a refund of Indemnified Taxes was received and also will want to ensure that the Borrower has no right to review the Lender's tax returns or related documents. The Lender should also include language

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that will protect it from having to pay over any amounts that would put it in a worse position than it would have been in had no such Taxes been withheld or imposed. For instance, a refund provision could provide the following:

> *Treatment of Certain Refunds*. If the Lender determines, in its sole discretion, that it has received a refund of Taxes as to which it has been indemnified pursuant to Section [*Indemnification by Borrower*] or received additional amounts pursuant to Section [*Taxes*], it shall pay to the Borrower an amount equal to such refund (but only to the extent of indemnification or additional payments made by the Borrower), net of all expenses (including Taxes) of the Lender and without interest, *provided however*, that the Lender will not be required to pay any amount to the Borrower to the extent such payment would place the Lender in a less favorable position than the Lender would have been in if the Tax giving rise to such refund had not been withheld or imposed and the indemnification or additional payments with respect to such Tax had never been made. The Borrower, upon the request of the Lender, shall repay any such amounts (plus any penalties, interest, or other charges imposed by the relevant Governmental Authority) in the event that the Lender is required to repay such refund to such Governmental Authority. In no event shall the Lender be required to make available its Tax returns (or any other information relating to its Taxes that it deems confidential) to the Borrower or any other person.

Withholding Documentation Requirements. Payments under a Credit Agreement may be subject to certain withholding taxes. For instance, U.S.-source interest income that is paid to a non-U.S. Lender is generally subject to 30 percent withholding tax unless it is reduced under the terms of a tax treaty.[3] In addition, U.S. federal income tax backup withholding at a rate of 28 percent could apply[4] and certain Lenders may be subject to withholding under FATCA.[5] While a comprehensive discussion of these withholding rules is beyond the scope of this article, in many cases, withholding taxes can be eliminated or mitigated by the delivery of certain documentation. For instance, the Lender can provide an IRS Form W-8BEN or W-8BEN-E to support the reduction or elimination of withholding taxes on U.S.-source interest income if an applicable tax treaty provides for such reduction or elimination. Similarly, a Form W-9 or an applicable Form W-8 may be sufficient to prevent the imposition of backup withholding or FATCA withholding.

Because the Lender is not always the party required to bear the ultimate cost for withholding Taxes that are imposed, Credit Agreements generally contain a provision requiring the Lender to provide documentation to the Borrower if it is necessary either to determine whether withholding is required or to reduce or eliminate withholding Taxes that would otherwise be imposed. If there is an Administrative Agent, it will want delivery of these documents as well so that it can make its own determination with respect to applicable withholding Taxes. A general provision can be sufficient for this purpose, providing simply that the Lender will provide any properly completed and executed documents reasonably requested by the Borrower or the Administrative Agent to secure an exemption from or reduction of withholding Taxes with respect to payments under the Credit Agreement, or to make a determination regarding the applicability of withholding Taxes. However many Credit Agreements, particularly Credit Agreements with Borrowers that are U.S. persons, will include a specific list of documentation that must be provided by U.S. Lenders and non-U.S. Lenders for U.S. federal withholding tax purposes, including for purposes of FATCA. The

[3] IRC §§ 881, 1442.

[4] IRC § 3406.

[5] IRC §§ 1471–1474.

Administrative Agent and the Borrower will generally want the Lender to be required to update these documents whenever they expire or otherwise become inapplicable, or to provide a notification if the Lender becomes legally unable to do so.

Some Lenders want the flexibility to elect not to deliver withholding documentation if providing that documentation would subject them to material expenses or they believe delivery would prejudice their legal or commercial position. In that instance, the question becomes whether withholding Taxes that are imposed, that could otherwise be avoided by the provision of such documentation, will be Indemnified Taxes. If the Borrower does not want to bear the risk of the Lender refusing to provide documentation but the Lender does not want to risk reduction of its expected return under the Credit Agreement, a compromise position can often be reached. For instance, the Credit Agreement could provide that the Lender must provide certain documentation or bear the cost of related Taxes (generally, documentation that is known to be applicable at the time the Credit Agreement is executed) and that the Borrower will pay Taxes related to other documentation the Lender reasonably determines it will not provide. Thus, the Lender knows that it will be required only to provide certain documentation in order to avoid additional Tax, and the Borrower knows it will not be required to pay additional Tax unless circumstances change and more onerous documentation is required of the Lender in the future.

Indemnification of Administrative Agent. The Administrative Agent will want to ensure that it bears no additional Taxes as a result of its position as the Administrative Agent. In order to achieve this, the Administrative Agent should require that a provision included in the Credit Agreement whereby the Lenders must indemnify it for any Taxes imposed on it and any related expenditures, whether they are Indemnified Taxes or Other Taxes that are subject to indemnification by the Borrower, or Excluded Taxes. Generally, this provision clarifies that the indemnification obligation of the Lenders does not relieve the Borrower of any of its indemnification obligations under the tax provisions discussed previously. This provision typically mirrors the language in the "*Indemnification by Borrower*" provision, including language that protects the Administrative Agent from the Lender refusing to pay on the basis that it does not believe a Tax was properly imposed. The Administrative Agent may also request that it have the ability to set off these indemnification obligations against amounts it would otherwise be required to pay over to the Lenders pursuant to the terms of the Credit Agreement.

Tax Representations and Covenants. A Credit Agreement typically contains representations by the Borrower with respect to its current condition and covenants by the Borrower with respect to actions it will take in the future. The Lender generally requests a representation regarding Taxes from the Borrower as confirmation that the collateral for the loan is not impaired (e.g., there are no tax liens) due to outstanding tax liabilities. Similarly, the Lender requests a covenant from the Borrower that it will comply with its Tax obligations in the future in order to prevent such impairment from occurring down the road. The representations requested are typically less onerous than in the context of an acquisition transaction, as the concern is only that the collateral not be materially impaired by outstanding Tax liabilities. The Tax representations typically provide that the Borrower has paid its Taxes and filed its Tax returns, that there are no liens for Taxes with respect to the Borrower, and that the accruals and reserves of the books of the Borrower with respect to Taxes are adequate. In the context of a Credit Agreement, it is not unusual for such representations to be qualified as to materiality, and provide for other exclusions, such as for Taxes that the Borrower is contesting in good faith by appropriate proceedings. The Tax covenants typically mirror the representations, requiring the same level of compliance going forward as was required at the time the Credit Agreement was entered into by the parties.

The Lender generally requests a representation regarding taxes from the Borrower as confirmation that the collateral for the loan is not impaired (e.g., there are no tax liens) due to outstanding tax liabilities. Similarly, the Lender requests a covenant from the Borrower that it will comply with its tax obligations in the future in order to prevent such impairment from occurring down the road.

Section 956 Considerations. As support for its obligations under the Credit Agreement, a Borrower may pledge certain of its assets as collateral, including the equity of its subsidiaries, and the subsidiaries may guarantee the obligations of the Borrower under the Credit Agreement as well. Typically, the Lender will seek to make these pledges and guarantees as broad as possible to provide the most security for recovery of the loan proceeds. There are many reasons that the Borrower might seek to restrict the collateral subject to pledge and the subsidiaries that act as guarantors. One such reason is potential tax liability under Code Section 956.

Generally, Section 956[6] will be of concern to Borrowers that are U.S. persons with foreign subsidiaries that qualify as "controlled foreign corporations" as defined in Code Section 957 (CFCs).[7] In certain circumstances, income generated by CFCs will be subject to taxation in the United States only once it is repatriated to the U.S. by means of a dividend.[8] In the absence of Section 956, if a Borrower that is a U.S. person were to receive credit support from its CFCs by means of a pledge or guarantee, it would be able to benefit from the earnings of the CFCs in the U.S. while avoiding the tax it would incur on a dividend of those earnings. In order to prevent this tax avoidance, Section 956 causes a deemed dividend from a CFC to its U.S. parent if the CFC provides certain types of credit support for the U.S. Borrower.[9]

In order to prevent tax avoidance, Section 956 causes a deemed dividend from a CFC to its U.S. parent if the CFC provides certain types of credit support for the U.S. Borrower.

A deemed dividend can be triggered if:

- A CFC guarantees the payment of loans made to a U.S. Borrower;
- Stock representing two-thirds or more of the voting power of a CFC is pledged as collateral for such loans; or
- A CFC's assets (including the stock of lower-tier CFCs) are pledged as collateral for such loans.[10]

In order to prevent any deemed dividend under Section 956 and the resulting tax liability, a U.S. Borrower will generally seek to exclude CFCs from any guarantee obligations under a Credit Agreement. In addition, the U.S. Borrower will seek to limit any pledge of stock of a first-tier CFC to 65 percent of the voting power, with no pledge of the stock of lower-tier CFCs. A prudent Borrower may also seek to limit guarantees and pledges by U.S. subsidiaries that hold no material assets other than the stock of CFCs, particularly where it has a U.S. subsidiary that acts as a holding company for its foreign operations. Although somewhat counterintuitive, a pledge by the U.S. Borrower of the debt of a CFC that is owed to the U.S. Borrower (including debt secured by the CFC's assets) should not create a deemed dividend under Section 956.

While a Lender generally wants the most potential credit support for its loans, and thus would tend to seek pledges and guarantees of the widest scope possible, a Lender must consider whether it is in its best interests to trigger tax consequences to the U.S. Borrower under Section 956, the cost of which could be significant and ultimately result in impairment of the collateral for its loan. It may be in the Lender's best interest to agree to provisions that are designed to avoid triggering tax liability under Section 956. However, these provisions can be narrowly crafted, such that they only exclude pledges and guarantees with respect to CFCs that would be likely to result in a material tax liability under Section 956.

There are certain circumstances under which the application of Section 956 would not trigger tax liability to the U.S. parent. For instance, if a first-tier CFC does not have accumulated earnings and profits and is not likely to generate earnings and profits in the future, a full pledge and guarantee with respect to such CFC should not result in material tax liability to its U.S. parent. Similarly, if all of a first-tier CFC's earnings and profits are actually or otherwise deemed repatriated each year, then the application of Section 956 should not result in material tax liability to the U.S. parent. In these and other circumstances, including all of the Borrower's CFCs in the limited pledge and guarantee provisions discussed above would be unnecessary and over-inclusive. As such, if the Lender desires to broaden the scope of pledges and guarantees, the limitations for purposes of Section 956 can be drafted to apply only to those CFCs, the full pledge or guarantee of which would be likely to result in material tax liability under Section 956.

[6] A full discussion of IRC § 956 is beyond the scope of this article; the discussion herein is an overview, intended only to illustrate the general considerations taken into account when negotiating the relevant provisions of a Credit Agreement.

[7] A wholly owned foreign subsidiary of a U.S. person that is treated as a corporation for U.S. tax purposes will generally qualify as a CFC. IRC § 957(a). If the subsidiary is treated as disregarded from the U.S. Borrower or is treated as a partnership this issue is not present. See Treas. Reg. § 301.7701-3.

[8] See generally, IRC §§ 951–965.

[9] IRC §§ 951, 956.

[10] Treas. Reg. § 1.956-2(c).

CONCLUSION

Entering into a Credit Agreement can be a complex process with a significant number of considerations for both the Borrower and the Lender. The allocation of Taxes pursuant to the terms of the Credit Agreement, as well as the allocation of tax risk, can have a material impact on the Lender's expected return on loans made pursuant to the Credit Agreement and should be considered carefully. Furthermore, the tax provisions can have a significant effect on the collateral and other security for a loan. The Lender and its tax advisors should thoroughly understand the tax provisions in a Credit Agreement and negotiate terms that will ensure that both its economic return and security support are protected.