

TAX CLAUSES IN SINDICATED LOAN AGREEMENT

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***Abstract.** Syndicated loan agreement allows for lenders often from different jurisdictions to finance the borrower and its project for which the loan is granted. The syndicated loan agreement comprises of tax clauses designed to regulate situations in which any funds transfer under the loan agreement may be taxed and generate additional costs. With the special role of syndicate agent, the loan agreement sets out rules for tax deduction and payment mechanisms.*

The purpose of this article is to introduce the reader to tax clauses of syndicated loan agreement with a focus of a role of a syndicate agent. Analysis of each tax clause will focus on determining the purpose of each tax clause and the purpose of tax clauses in syndicate of a loan agreement in general.

***Keywords:** Syndicate loan, tax clause, tax gross-up, tax deduction, additional costs.*

Introduction

This article investigates the influence of the characteristics of syndicated loan on the tax clauses in a loan agreement. The tax clauses are closely related with all types of loan agreements. The funds granted to the borrower by the lenders are subject to tax law and it is a matter of determining under what tax rules the funds are regarded. The income tax and VAT tax must be considered while analyzing under what rules the funds are or can be potentially taxed. The syndicate loan in particular must be considered with different jurisdictions of which syndicate banks and borrower originate. The loan agreement stipulates several tax clauses relating to income tax and VAT designed to offer solutions in situations where tax law requires additional costs and payments to be made in relation with the funds granted by syndicate banks to the borrower. The purpose of tax clauses in the syndicate loan agreement should be determined in this article. In order to establish that mostly the dogmatic method of analyzing tax clauses will be applied.

Syndicated loan characteristics

The bank syndicate known also as bank consortium is a temporary alliance formed by banks for the purpose of granting a loan under the provisions of the loan agreement. Recurrently, a bank syndicate is composed of banks with registered offices in various countries. In a structure of a syndicated loan one of the banks usually uptakes the role of syndicate agent, acting both as a representative of the bank syndicate and responsible for financial operations stipulated by the parties of loan agreement between banks acting as lenders and the borrower. Both in practice and in literature on the subject, two basic types of banking syndicate are differentiated, a credit consortium constructed for purpose of granting a single loan to a specified entity. Second type is a banking consortium designed to finance a specified entity or a group of entities over a longer period of time through concluding subsequent loan agreements [1]. The second type of bank syndicate is also constructed through separate syndicate agreement, while the first is usually based on provisions included in a loan agreement [2].

Both configurations of bank syndicate provide for the borrower's obligation to make all due payments to the syndicate agent. All repayments, interest payments and other fees must be paid to the syndicate agent who is then responsible to distribute acquired funds to other lenders – participants of bank syndicate. A crucial question arises in connection with above mentioned payments as to who is the payer of income tax from legal persons under interest from the loan. Should the borrower first determine its tax duties with respect to the withholding tax payer and then apply provisions of double taxation agreements concluded between the country of its residence and the country of tax residence of the syndicate agent? Alternatively the tax duties could be determined in respect to the agreements concluded between the country of borrower's residence and the country of tax residence of the individual borrower – participant of bank syndicate.

For the purpose of determining whether Corporate Income Tax should be applied to payments made under the a loan agreement to the syndicate agent firstly the tax residency should be established. Secondly it should also be established if the payments made to the syndicate agent should be considered to

be whole income for him or only in part corresponding to his involvement in the total financing by lenders. Several tax clauses in loan agreement are designed to determine these factors notwithstanding the jurisdiction in which the financing is taking place [3].

Tax gross-up clause

Tax gross-up clause is a basis clause ensuring the lenders that two conditions will take place: their payments will not be decreased for the reason of tax mandated by the law applying to such payment or lenders being unaware that such tax is mandated by the law. The tax gross-up clause provides for the obligation of the borrower that the payments shall be made without deductions on account of any taxes, unless the borrower, according to the provisions of any law, is obliged to deduct tax on account of the payments [4]. In the event when such tax deduction is required on the amounts which are to be paid or were paid by the borrower, additional amounts must be paid in order to ensure that the net amount received by the lenders equals the full amount the lenders would receive, if the tax deduction was not required on such payment.

The syndicate agent has certain rights but also certain obligations under the loan agreement that relate to the so called day-to-day administration of the syndicated loan. First and most important role of the syndicate agent is to be mediatory between parties of the loan agreement in term of payments. The flow of payments must be ensured in bank syndicate. The syndicate agent is responsible for receiving payments from the borrower and then divide the amounts obtained between the lenders entitled to receive them in accordance with the provisions of the loan agreement.

In general, the role of syndicate agent is mostly technical and does not extend beyond accounting functions mentioned above. Importantly the loan agreement indicates that the legal title to the amounts paid by the borrower, except for the part which is due to the syndicate agent as a lender, remains with the lenders, not the syndicate agent. The share of specific lender is generally established in a loan agreement, but the provisions regulating the relationship between lenders and syndicate agent can be additionally regulated in syndicate agreement which may be formed in connection with the loan agreement or as a separate set of documents. In syndicated loans the syndicate agent has ordinarily its registered office in the same jurisdiction as the borrower, although it is not an obligatory matter, as the syndicate agent may be also a foreign bank. In the second scenario, the bank performing the role of syndicate agent as well as other syndicate participants may be subjected to taxation of their income in countries other than the country of origin of the borrower [5].

Tax gross-up clause is notably important in situations in which some or all of the banks participating in the bank syndicate have their registered offices and established tax residence in countries other than country of origin of the borrower. Such banks will usually participate in the syndicate through their office branches established in country of origin of the borrower (or possibly branches in other countries within the European Union if the borrower is an EU member). Those foreign banks are also not tax residents nor are they subject to unlimited tax liability in the country of origin of the borrower. When the

payments from the borrower are due the syndicate agent will transfer the payments to the branches of foreign banks due to them under the loan agreement [6].

As widely recognized standard market practice the loan agreement specifies that in the event that the amount of interest is payable in country of origin of the borrower withholding tax, the amount of interest paid by the borrower should be increased in such a way that the syndicate agent receives the net amount of interest agreed in the loan agreement after the deduction of withholding tax is made. This provisions allows for all banks participating in the syndicate to be able to actually receive the amount of remuneration agreed upon in the loan agreement.

Also, the loan agreement states that if the borrower is required to collect tax on the interest in country of origin of the borrower, the syndicate agent will be entitled to the expanded amount of interest paid to the syndicate agent in such a way that the amount of net interest payable to banks participating in the syndicate after tax must be equal to the amount of interest due in the absence of such tax. In other words, the loan agreement introduces a mechanism for extending the amount of interest due to banks participating in the syndicate so that the net amount payable to the those banks was equal to the amount specified in the loan agreement in the case of the obligation by law to pay withholding tax on interest in the country of origin of the borrower. This gross-up mechanism is specified in detail in tax gross-up clauses of the loan agreement, especially in syndicate financing with participants from different tax jurisdictions. The purpose of this mechanism is to protect the recipients of payments due to the banks against a potential reduction of their remuneration in the event of obligation to collect tax on such payments in country of origin of the borrower.

It is mostly agreed that the interest paid to the syndicated agent in relation to the syndicated loan granted to the borrower is related to the borrower's revenues as costs related to the financing of the borrower's operations. However with tax gross-up mechanism in place in most syndicate financing loan agreement a question arises whether the interest on the due payments increased by the amount by which the interest indicated in the loan agreement is increased by a tax gross-up mechanism are also a deductible cost related to the financing of the borrower's operations [7]. It must be noted that the amount by which the interest payable to the syndicate agent will be increased in the event of grossing up is in fact an additional amount of interest that the borrower is required to pay to the syndicate agent if it is necessary to collect the withholding tax on interest payments.

The additional cost resulting from taxation of loan burden on the borrower leads to increase in the amount of interest owed to the banks participating in the bank syndicate. The gross-up mechanism has one significant purpose of eliminating the negative effects for the banks resulting from withholding tax. Economically it also constitutes a justified service for the borrower to pay additional amount of interest under the gross-up mechanism. Through executing the loan agreement the borrower agrees that the additional costs resulting from the obligation to pay withholding tax will be charged to the borrower [8]. Even though in general syndicate banks are liable for additional costs in relation to loan agreement [9]. In other words, the conclusion of the loan agreement is a prerequisite for obtaining payments from the loan agreement in terms of the increased amount of interest in the event of taxation of interest

in country of origin of the borrower. Naturally, the banks participating in the bank syndicate are focused only in the amount of net interest that the syndicate agent transfers to them and are due in accordance with the loan agreement.

As mentioned above, the gross-up clause is widely used in loan agreements concluded by banks participating in syndicates as a standard market practice. Additionally, from the borrower perspective it should be emphasized that a relationship exists between incurring payments of additional interest amounts in accordance with gross-up clause to the syndicate agent and revenues due to the use of amounts awarded to the borrower under the loan agreement [10].

The gross-up clause does not implicate any obligation on the side of the borrower to pay any amounts other than interest (i.e. additional commissions), nor does it provide for the borrower to pay its own withholding tax due from banks for their income in the form of interest. After the use of gross-up mechanism set out by the gross-up clause in the loan agreement, the amount by which the interest is increased should be after deducting the withholding tax should result in the amount of net interest which is due to the banks participating in the bank syndicate under the loan agreement. Additionally in that sense the interest payable to the banks after tax should be equal to the amount of interest due to the banks in situation of absence of tax in country of origin of the borrower.

VAT clauses

The most significant role of VAT clauses in the loan agreement is to determine if any VAT should be considered by the borrower when making payments under the loan agreement. As a general rule the VAT clauses consider that any payments expressed to be payable to the syndicate banks under the loan agreement shall be deemed not to include VAT [11]. This general rule applies to any payments including repayments, interests and any additional commissions due to the banks in accordance with loan agreement. However, if VAT is chargeable on any supply made by any of the parties of loan agreements to any other party, then under the loan agreement, the borrower shall pay to the bank (in addition to and at the same time as paying the consideration) an amount equal to the amount of the VAT.

Also, the loan agreement requires the borrower to reimburse the syndicate banks for any costs or expenses, the borrower shall also at the same time pay and indemnify the syndicate banks against all VAT incurred by the syndicate banks in respect of the costs or expenses to the extent that the syndicate banks (often with a clause obliging the banks to act reasonably) determines that it is not entitled to credit or repayment of the VAT. Obligations resulting from provisions in this VAT clause often stipulates that all costs and expenses due to the syndicate banks are to be made to the syndicate agent. It should be also added that in the bank syndicate the syndicate banks are not liable for each other [12].

Another VAT related clause is relating to so called “VAT refund account” an constitutes for a form of collateral securing claims of syndicate banks [13]. In accordance with VAT refund account clause the borrower must undertake to identify to the tax office appropriate for the borrower's registered office, before the first utilization date, the VAT refund account as the only account appropriate for making VAT refunds and it shall not change this account during all financing period under the loan agreement. Additionally, at the same time, the VAT clause stipulates borrower’s obligation to deliver to the syndicate agent the original or a certified copy of the form with the presentation of the competent tax office specifying the VAT refund account as the only account for refunding the VAT to the borrower by appropriate tax authorities - with such content as may be satisfactory to the syndicate agent. The VAT refund account is the borrower’s account blocked in the syndicate agent’s favour. The borrower without the syndicate agent’s consent may not withdraw any amount from the VAT refund account during the financing period, it does not apply to VAT amounts refunded to the borrower the payment of which was not financed or re-financed using the loan. Immediately after the loan availability period and the repayment of all utilization within the loan, the borrower must have an obligation to submit a request to close the VAT refund account.

One of the possible types of loans that banks grant to the borrowers, also in a form of syndicate is a VAT loan. Under the terms and conditions of the loan agreement the bank syndicate undertakes to make available to the borrower the revolving VAT loan within the VAT loan availability period [14], up to the amount of the VAT loan commitment granted for the purpose that the borrower shall apply all amounts borrowed by it in the VAT loan to partial finance (or partial refinance) of the VAT tax, which is due in connection with the implementation of the project being financed by the loan granted under the loan agreement.

The borrower may utilize the VAT loan submitting a duly completed utilization request to the syndicate agent. Each utilization request should be submitted to the syndicate agent, after the providing the syndicate agent with the report, before the proposed utilization date. Furthermore the loan agreement stipulates that the final repayment of the VAT loan shall take place not later than on the VAT loan final repayment date, using specific funds as specified by the loan agreement. Also, if the borrower receives VAT refund before repayment of the utilization in the VAT loan. Such VAT refund shall be applied towards the repayment of the utilization in the VAT loan on the closest payment date of interest. On each such interest payment date the syndicate agent shall charge the borrower’s account specified for that purpose, for which purpose the borrower grants the syndicate agent the irrevocable power of attorney [15]. However any repayment made pursuant to that provision is not be regarded as prepayment. The VAT loan can be granted in a form of a revolving loan and the borrower shall have the right, during the VAT loan availability period, to re-borrow from the VAT loan the funds, which have been already repaid. But in the event the borrower makes the voluntary prepayment of the debt amount on account of the VAT loan, the borrower shall pay the lender interest on the VAT loan amount repaid earlier, calculated until the day of the prepayment and not paid by the borrower, as well as prepayment fee of the debt amount on the account of the VAT loan of such prepaid debt amount. The borrower does not need to know how the bank implements procedures in the field of credit risk management, but through the above mentioned clauses it certainly is aware of their existence [16].

Conclusions

Syndicated loan agreement allows for the parties of syndicated loan agreement to stipulate a party responsible for collection and payment of any tax that is due in connection with the loan agreement. In particular the gross-up clause and VAT clauses are being designed in a way that the flow of funds between the borrower, syndicate agent and other syndicate banks are done without an ultimate cost encumbering the banks.

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