C A D W A L A D E R

In the News: (Potentially) Taking Revenge Through Tax

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As we power through what remains of this quarter, working to get deals closed before quarter end next week, you may have noticed some additional (and new!) blacklining in the tax section of your credit agreement thanks to a bill that is currently in the Senate. We are seeing new terms coming into credit agreements to include certain language in the tax provisions that wasn't there before.

In our last *Fund Finance Friday* for the quarter, we dive into what's driving these eleventh hour comments, how they are being dealt with, and who bears the risk of this so-called "revenge tax" when it comes to your fund finance deal.

This is a very live and developing issue with changes occurring just yesterday afternoon that we are watching very closely. Here we will dig into the issues but note that yesterday afternoon Treasury Secretary Scott Bessent asked House and Senate Republicans to remove the revenge tax on the basis that the U.S. had reached a "joint understanding" with G-7 allies that would exclude U.S. companies from certain taxes imposed by other countries in exchange for removing Section 899 from the amendments to the Internal Revenue Code contained in One, Big, Beautiful Bill. Notwithstanding this, the bill remains before the Senate this morning and indeed still contains the revenge tax. We know our clients and readers are watching this issue closely and so we are digging in here with the latest.

Last month, the U.S. House of Representatives passed the bill, which includes the addition of proposed Section 899, which is being referred to as the "revenge tax." Section 899 imposes increased tax rates on governments, business entities, and individuals that impose so-called "unfair foreign taxes" on U.S. tax payers and their subsidiaries. Essentially, it is a response to unfair taxes that works by increasing the rate of tax that would be applicable to certain taxpayers that are related to a foreign jurisdiction. The draft bill describes a number of taxes that lawmakers have determined to be unfair taxes and it gives the Treasury Secretary the authority to designate additional unfair taxes. Section 899 has potentially far-reaching consequences and in our particular corner of the world there are consequences for foreign banks and lenders making loans to U.S. borrowers, foreign investors in debt funds and other investment vehicles, and these rates would apply to foreign investors that are making certain investments in the U.S.

The genesis of all this dates back to discussions among the members of the G-20 and the Organization for Economic Cooperation and Development (the "OECD") that led to an agreement allowing foreign countries to change their tax rules to impose a global minimum tax rate of 15% on multinational corporate groups with annual revenue over EUR 750 million. This framework, known as "Pillar Two" allowed each member country to enforce this global minimum by taxing local subsidiaries on income earned in other countries. (For example, if a multinational group had subsidiaries in both Germany and the Cayman Islands, and the Cayman Islands did not tax the income of the Cayman sub, Pillar 2 would call for Germany to step in and impose what is called a "top-up tax," taxing the German subsidiary on the income of its Cayman sister subsidiary in order to ensure that the group was subject to a 15% tax on all of its income, no matter where it was earned.) Some lawmakers object to the extraterritorial effect of this tax on U.S. multinational companies. Section 899, which was written by House Republicans and supported by the President, is designed to respond to this extraterritorial taxation.

Yesterday, Treasury Secretary Bessent took to X and other social media platforms and said that as a result of the deal he cut with other members of the G-7, "OECD Pillar 2 taxes will not apply to U.S. companies, and we will work cooperatively to implement this agreement across the OECD-G20 Inclusive Framework in coming weeks and months." He noted that "[b]ased on this progress and understanding, I have asked the Senate and House to remove the Section 899 protective measures from consideration in the One, Big, Beautiful Bill."

As you may recall from social studies, a bill becomes a law after it is approved by both the House of Representatives and the Senate and it is signed into law by the president. The bill is now sitting with the Senate and the Senate Finance Committee released its version of the bill on June 16th and Section 899 remains a part of it. The Senate draft gives the president some extra power when it comes to serving up revenge in that it gives the president discretion to double taxes on corporations and citizens of countries that impose unfair foreign taxes on U.S. entities and individuals.

So how does all of this factor into your credit agreement? First, keep in mind that Section 899 is only going to be relevant where there are lenders that are non-U.S. entities in the deal. In a deal with a U.S. lender these negotiations will not come up because Section 899 would not apply. However, it is possible that a borrower and a U.S. lender may determine to include provisions addressing the revenge tax in their credit agreement if the parties were anticipating that a non-U.S. lender would come into the deal through syndication.

So what do unfair foreign taxes and revenge taxes have to do with fund finance? Lenders are in the business of making loans to earn a profit and they expect to have to pay taxes on the interest, fees, and other income they earn for making a loan. They want it to end there and have other costs of doing business covered by the borrower (just the way that someone who purchases something in a store pays for the item and pays the sales tax as well). To that end, generally speaking, the tax provisions in a credit agreement provide that whatever taxes a lender has to pay that are directly attributable to the loan as a cost of doing business (other than the income tax mentioned above) will be passed on to the borrower. For example, a country may impose a withholding tax on interest payments that a borrower that is making to a lender in another jurisdiction. While it is the lender's responsibility to pay the tax, the laws of the country may require that the borrower withhold amounts in its country before sending the payment to the lender in another country. This helps ensure that the tax gets paid. The Lender is then expecting the Borrower to pay the taxed amount over to the Lender or otherwise gross them up.

As it relates to Section 899, there are a couple of different philosophical perspectives. It is currently not law but it is definitely something parties are aware of. A borrower may take the position that it is an existing day-1 tax that should be factored into the pricing of the deal. On the other hand, given that it is not currently the law, many lenders believe they should not bear the risk of it and they should be covered or indemnified by the borrower under change in law provisions under their credit agreement which have the borrower cover unanticipated costs of a lender if the law changes during the course of the deal.

Going back to taxes a lender may need to pay in a foreign jurisdiction, the rate of tax will vary country by country and will be determined by the presence and terms of any tax treaties. Treaties will determine the tax rate and whether there needs to be withholding at all. For example, interest paid by an English borrower to a U.S. lender is not generally subject to withholding due to a tax treaty between the countries. With this background in mind, ***Indemnified Taxes*** under a credit agreement are the taxes where the borrower will gross-up the lender. On the other hand ***Excluded Taxes*** are those taxes which are excluded from the gross-up.

We are seeing a few approaches by fund borrowers and lenders in our deals. In some cases, the borrower will seek to shift the entire risk and burden of the tax to the lenders by adding the taxes imposed or collected pursuant to Section 899 to the definition of Excluded Taxes. Tax obligations pursuant to Section 899 can also be a carve out from Indemnified Taxes the way that Excluded Taxes are. This means that any tax that the lenders may need to pay as a result of Section 899 will not be grossed up by the borrower. Some lenders are accepting that construct.

In other cases, the parties may decide to split the impact of the risk where there is a foreign lender in the deal through a bespoke arrangement whereby the parties share the cost - meaning that the borrowers are only responsible for part of it. And there are still deals being worked out where borrowers are making comments that lenders are flat out rejecting and it will be interesting to see how this is resolved as time runs out on quarter end.

Section 899 still needs to pass the Senate before it becomes law and it could evolve further before that happens. For example, the Senate's draft expressly exempts portfolio interest from increased rates while the House bill was less clear on that point. If the portfolio interest exemption survives final passage, that would substantially blunt the effect of Section 899 for most non-bank lenders.

There is still concern that if this were to be enacted into law it could deter certain foreign investment into the U.S. Those in favor of Section 899 generally take the position that the provision will rarely be enforced because its existence will motivate countries that impose “unfair taxes” on U.S. taxpayers to repeal those taxes or put in place exemptions for U.S. companies.

We will continue to follow this as it develops.

For more on the substance of this bill and this subject, please see our tax team’s newsletter BrassTax **here**.