KEY POINTS

- The risk of being required to withhold UK income tax on payments made by lenders of record under English law governed sub-participations can be mitigated by careful drafting.
- Methods of mitigating lender credit risk in sub-participations may lead to additional tax consequences.
- Where those methods of mitigating lender credit risk result in the participant being the beneficial owner of interest paid under the underlying loan, then in certain situations the participant may not be able to enjoy exemption from UK withholding tax on those interest payments.

Feature

Authors Adam Blakemore and Oliver Iliffe

Sub-participations, taxation and the mitigation of lender credit risk

This article principally focuses on the reduction of lender credit risk in the context of funded sub-participations, and the tax consequences of doing so.

As has previously been noted by other authors in this journal, recent events in the financial markets have resulted in the reassessment of counterparty risk. Participants in the secondary loan market have expressed particular concerns over the exposure of participants to lenders of record under sub-participations that have been entered into under standard form Loan Market Association ('LMA') documentation. This article focuses on certain taxation consequences which may accompany attempts to mitigate the credit risk in these circumstances.

For the sake of simplicity, the transferor/ lender of record/seller of the risk in the sub-participation will be referred to as a 'lender of record' and the participant/transferee/ buyer of risk in the sub-participation will be referred to as the 'participant'.

REASONS FOR SUB-PARTICIPATION

A lender of record may wish to decrease its exposure to the borrower, to diversify its loan portfolio or to release regulatory capital. The obvious advantages for the participant would be obtaining credit exposure to the performance of the borrower without being the owner of the debt, thus avoiding direct exposure to a particular country, industry or corporate. Compliance with the restrictions in the loan agreement and the absence of any relationship with a particular borrower may also be amongst the reasons for using sub-participations. In addition, a participant may want to achieve, as between itself and the lender of record, a different risk profile (for example, different duration of the exposure) than as between borrower and lender under the original loan.

Under the LMA's standard documentation for 'funded participations', the participant pays the lender of record an upfront lump sum payment (calculated on the outstanding amount of the loan) that is non-refundable. The purpose of the payment may be to enable the lender of record to fund all, or part, of the loan. In consideration for the payment by the participant, the lender of record covenants that it will pay an amount to the participant equal to any amount which it has 'applied' following actual receipt of such amount from the borrower under the loan, whether the amount is of interest, principal or any other amount. From a regulatory perspective, these arrangements enable the lender of record to remove its exposure to the borrower's repayment obligation from its supervisory balance sheet. That repayment obligation is instead included in the participant's balance sheet as a claim on the underlying borrower. The funded sub-participation is also designed to ensure that the loan asset is derecognised on the lender of record's accounting balance sheet.[1]

This article focuses on the tax consequences of lender credit risk solely in the context of funded sub-participations.

English law-governed sub-participations have been held by the Privy Council to constitute limited recourse, back-to-back funding arrangements which do not change the beneficial ownership of the underlying loan asset or interest or other payments made under that loan.[2] This treatment is also respected for UK tax purposes. The participant therefore assumes a 'double credit risk' on default by either or both of the borrower and the lender of record. The existence of this 'double credit risk', coupled with the recent financial crisis, prompted the LMA to publish a document entitled 'Funded Participations – Mitigation of Grantor Credit Risk' in January 2010 (the 'LMA Memorandum') in which six possible approaches to the question of mitigating credit risk were considered.

In attempting to mitigate the credit risk inherent in a sub-participation, consideration must be given to the tax consequences of the possible options available to achieve this aim.

UK TAXATION OF SUB-PARTICIPATIONS

Before considering the effect of the tax changes which may result from the implementation of the different approaches in the LMA Memorandum, it is worth considering the taxation treatment of English law sub-participations. The key question relates to whether payments made under a market standard sub-participation agreement (such as the 'LMA Funded Participation (Par)' document) would be subject to withholding of UK income tax.

Beneficial entitlement to interest: Broadly speaking, a carefully drafted English law sub-participation should not change the UK withholding tax position between borrower and the original lender, who will remain beneficially entitled (under English law) to interest paid on the underlying loan.

It is important to note that in the context of double taxation treaties, Her Majesty's Revenue & Customs ('HMRC') may seek to apply an 'international fiscal meaning' of beneficial ownership,[3] as considered in the *Indofood* case,[4] where HMRC considers there has been abuse of a double taxation agreement. Such circumstances might arise if a participant which was not entitled to treaty benefits arranged to participate in a loan through an intermediate lender of record resident in a treaty jurisdiction and that intermediate lender was able to take advantage of an exemption or reduction of withholding tax under a double tax treaty with the UK.

The consequences of such an arrangement might be denial of treaty benefits by HMRC as regards the interest paid to the intermediate lender of record, being a consequence following from HMRC refusing to respect the construction of an English law governed sub-participation agreement as not changing the beneficial ownership of the underlying loan.

It is considered that the number of occasions of such 'improper use' of a double taxation treaty in the context of sub-participation are likely to be infrequent. While the taxation consequences of entering into a sub-participation are important, it is considered that these will usually remain ancillary and subordinate to the non-tax reasons behind the participation.

Absence of 'interest': Payments made by the lender of record to a participant under a sub-participation agreement governed by English law should not be regarded as a payment of interest, owing to the term 'interest' being construed in a UK withholding tax context by reference to the natural and judicial meaning of the word and not by reference to economic substance.[5] The usual requirement to consider the exemptions from withholding tax on payments of 'interest'[6] should therefore not be relevant to payments made by a lender of record under an English sub-participation.

'Annual payment' considerations: It is also necessary to consider whether the payments made under the sub-participation agreement might constitute 'annual payments' which would be subject to a withholding of UK income tax when paid by the lender of record. The term 'annual payment' does not have a statutory definition but has been defined in case law to mean an income payment which is made under a legal obligation, which has the quality of recurrence and which constitutes pure income profit in the hands of the recipient. Depending on the particular circumstances of the sub-participation, it may be possible to conclude that payments under the sub-participation constitute a capital receipt in the hands of the participant (thereby preventing them from being annual payments, and subject to withholding), but it is submitted that these circumstances are likely to be infrequent and atypical.

It may also be possible to identify that payments made to a participant do not constitute 'pure income profit'. This is a complex test, owing to the somewhat unclear nature of precisely what payments constitute 'pure income profit', a concept derived from case authorities. The relevant test is whether the payment is a taxable receipt in the hands of the recipient without any deduction for expenses or costs.[7] Where payments under a sub-participation agreement are paid to a participant carrying on a taxable trade, and the participant is entitled to deduct expenses from the receipt of that payment, payments would not be 'pure income profit' and would not constitute annual payments subject to withholding of UK income tax.[8]

This deceptively simple test is complicated materially where the recipient of the payment is either a tax exempt person or is located outside the scope of UK taxation. This will be a frequently encountered situation, owing to the number of non-UK resident funds which participate in loans rather than acting as lenders of record. Where a participant is resident in a jurisdiction which imposes taxation on payments made under the sub-participation it may be possible to rely on the business profits article of an applicable double taxation treaty between the UK and the participant's jurisdiction to relieve the lender of record from the need to withhold (subject to completion of the necessary treaty formalities).

Mitigating the risk of 'annual payments': If the participant is resident in a non-taxing jurisdiction (such as the Cayman Islands), it might be possible to reach the view that the sub-participation payments are not pure income profit where those payments are taken into account as income in the profit and loss account of the participant, with expenses of the participant's business being set against such income.[9]

However, in the circumstances of a tax haven resident participant, the residual risk of payments under the sub-participation being treated as annual payments, coupled with the lack of a gross-up clause in market standard sub-participation documentation, frequently prompts the participant to request amendments to the market standard sub-participation documentation to counter that risk. This can be achieved in a number of ways, such as by documenting the relationship between the lender of record and the participant as a loan made on limited recourse back-to-back terms[10] (thereby permitting a UK bank lender of record to pay 'interest' to the participant within the ordinary course of that UK bank lender's business without withholding), or as a total return swap.

Even where a participant in a non-taxing jurisdiction is comfortable that payments under a sub-participation do not constitute annual payments, some UK tax consequences can still arise. A company which is not resident in the UK and which is not carrying on a trade in the UK through a permanent establishment may be subject to UK income tax on UK source income where that income is received without deduction of tax and is not within the definition of 'disregarded company income'.[11] The tax charge is only applicable where a trade is carried on by the participant within the UK and no relief is available.[12] In practice, these circumstances are likely to be remote and any assessment by HMRC of the resulting liability may be difficult to enforce in practice.

From the above discussion of the taxation of sub-participations, it can be seen that the particular treatment of such arrangements under English law, and in particular the retention of beneficial ownership in respect of the underlying loan (and the interest and proceeds arising therefrom), dictates the UK taxation treatment of a sub-participation. Consequently, a number of the variations suggested in the LMA Memorandum as a means of mitigating lender credit risk for the participant, which would result in changes in the beneficial ownership of interest payments under a sub-participated loan, would have a material impact on the UK tax treatment of the sub-participation arrangement. These mitigating approaches and their attendant UK tax consequences are considered in the rest of this article.

DECLARATION OF TRUST

The first mitigatory approach considered in the LMA Memorandum is for the lender of record to declare a trust over the relevant loan asset (including the loan proceeds) in favour of the participant, thereby establishing a proprietary interest in the loan (and proceeds) in favour of the participant as a beneficiary under that trust. Following the declaration of trust, the participant would be the beneficial owner of interest paid under the underlying loan. This situation is analogous for tax purposes to the position that would apply if the loan had been assigned. Such an approach to the mitigation of lender credit risk may be acceptable where the taxation status of the lender of record is the same as that of the participant, such as, for example, where both are subject to UK corporation tax.

However, where the taxation status of participant and lender of record is different, a number of material tax consequences may arise. Although the lender of record may be a person to whom the borrower would be able to pay interest without UK withholding, such as a bank falling within the scope of s 991 of the Income Tax Act 2007, the taxation characteristics of the participant may be different. In particular:

- the participant may not be able to enjoy the same exemption from UK withholding tax on payments of interest. For example, the participant may be located in a jurisdiction with which the UK has no double taxation agreement containing an interest article, such as a fund company resident in the Cayman Islands; or
- the participant may be able to enjoy an exemption from UK withholding tax on interest payments, but only if certain steps are taken. For example, if a participant is resident in a treaty jurisdiction, withholding tax would be imposed unless and until the borrower had submitted an application to HMRC for relief from withholding at source which HMRC duly granted.

It should also be noted that the borrower's obligation to withhold income tax from interest payments is an absolute obligation, and is not affected by whether the borrower has received notice of a declaration of trust over the loan. If there is no requirement in the loan documentation for the lender of record to notify the borrower of a change in beneficial entitlement to interest on a declaration of trust being made, the borrower may not be aware of its liability to withhold. If the borrower becomes aware of this change at a later date, it may need to make withholdings on account of previously unpaid income tax and interest for late payment against future interest payments.

If the loan documentation contains a requirement to inform the borrower of a change of beneficial ownership in the interest paid to the lender of record, this will alert the borrower to both the declaration of trust and the fact that a sub-participation of the loan has taken place. In the event that the participant is not able to receive interest without withholding (because it is not able to claim the benefit of a treaty and is not within the exemption for beneficial owners within the charge to UK corporation tax), the borrower would be entitled to withhold income tax from payments of interest made to the lender of record, most probably without being required to gross up the interest payments being made following the withholding.

In the event that the lender of record is a lender in a treaty jurisdiction and is receiving interest gross under a treaty direction from HMRC, the lender will be required to inform HMRC of any change to the information provided to HMRC when the treaty direction was given. This is likely to include the details of the transfer of beneficial interest in the interest under the declaration of trust.

Where a lender of record is receiving net payments of interest (ie subject to withholding), but with the benefit of a tax credit, any transfer of beneficial interest to the participant may result in the tax credits not being available to the participant beneficiary, further increasing the cost and economic unattractiveness of the declaration of trust for such a participant.

GRANT OF SECURITY

A further option suggested in the LMA Memorandum is the grant of a security assignment by the lender of record in favour of the participant over the lender of record's rights to receive payments under the underlying loan documents and over the account into which the loan proceeds received under the loan document are paid. In the event that notice is served by the participant in respect of the security, however, a number of issues arise which are similar to those regarding a transfer of beneficial interest under a declaration of trust (described above).

Where the security assignment only involves a transfer of legal title (and not beneficial ownership of the interest) to the participant, the security arrangement should not, by itself, impact on the UK withholding tax analysis.

NOVATION OF LOAN TO A LENDER OF RECORD AFFILIATED TO A BANKRUPTCY REMOTE SPV

One of the options considered, but rejected, in the LMA Memorandum was for the underlying loan to be transferred by novation in accordance with the loan documentation to a bankruptcy remote special purpose vehicle ('SPV') affiliated or grouped with the lender of record. Following the novation, the SPV would be able to grant a participation in the loan to the participant, thereby mitigating the credit risk against the original lender of record.

The conclusion drawn in the LMA Memorandum that 'this option has significant tax concerns and is therefore unlikely to be an attractive risk mitigation option'[13] is perhaps an overly conservative approach to what may be considered to be a practicable restructuring of a sub-participation. Provided that a suitable, treaty eligible SPV can be located, it should receive interest as a qualifying lender under the novated loan without withholding of UK tax and should be able to make payments under the new sub-participation (or other financing arrangement, such as a back-to-back non-recourse loan or total return swap) agreement without withholding for the reasons explored above.[14] While the LMA's concern that UK banks 'have a general withholding tax exemption for interest paid out in the ordinary course of their business but an SPV would not'[15] is not inaccurate in and of itself, it does not recognise that such an exemption would not necessarily be the one relied on by a UK bank in making payments under a sub-participation agreement in the first place.

CREDIT SUPPORT

Alternatively, the lender of record may provide credit support on entering into the sub-participation or on the occurrence of a trigger event such as a ratings downgrade, similar in structure to the credit support requirements under International Swaps & Derivatives Association documentation

Feature

Biog box

Adam Blakemore is a tax partner in the London Office of Cadwalader, Wickersham & Taft LLP. Email: adam.blakemore@cwt.com

Oliver Iliffe is a tax associate in the London Office of Cadwalader, Wickersham & Taft LLP. Email: oliver.iliffe@cwt.com

(which trigger on mark to market values). The taxation consequences of such an option are related to the nature and type of the collateral chosen for credit support, and the identity and jurisdiction of the parties.

ELEVATION OF SUB-PARTICIPATION

The LMA Memorandum also suggests that the lender of record may, on the occurrence of a trigger event (such as a ratings downgrade or market disruption) be required to transfer the loan to the participant, thereby 'elevating' the loan and effecting a transfer of the loan to the participant. The result of such an elevation in a tax context would be material, resulting in beneficial ownership of the interest under the loan by the participant, with consequences similar to those considered above in the context of a declaration of trust.

SUB-PARTICIPATION DOCUMENTED UNDER NEW YORK LAW

The final mitigatory option considered in the LMA Memorandum is that a funded sub-participation may be documented under New York law. The current Loan Syndication and Trading Association model form of sub-participation agreement provides that the lender of record sells, grants and conveys an undivided 100 per cent participation interest in the loans, the commitments and the transferred rights. The lender of record retains only the legal title in the underlying loan and commitment for the benefit of the participant. As a matter of New York law, the participant is intended to acquire a beneficial interest in the underlying loan such that receipts by the lender of record under the loan documentation that are subject to the sub-participation are ring-fenced on the lender of record's insolvency.

As noted in the LMA Memorandum, uncertainty remains over how a New York law sub-participation should be construed as a matter of English law. The most likely construction appears to be that such a sub-participation constitutes an assignment of the underlying loan proceeds or a declaration of trust over them, both of which would involve the participant acquiring a beneficial ownership in the interest paid under the loan. The consequences would then follow those outlined in the declaration of trust option discussed above. While the New York law sub-participation is essentially intended to be a 'silent participation', a number of the circumstances which are germane to the UK withholding rules, under which the lender of record would need to inform the borrower of that sub-participation, would negate some of the perceived advantages of the silent nature of a New York law sub-participation.

CONCLUSION

Several of the approaches for mitigation lender credit risk listed in the LMA Memorandum can therefore be seen to have material taxation consequences for English law sub-participation agreements, requiring a careful consideration of the taxation characteristics of the participant and the overall sub-participation arrangement. Only by reaching a solution which mitigates both actual tax costs and potential tax risks will the purported aim of mitigating the lender credit risk assumed by the participant in a sub-participation be commercially practicable. ■

1 International Accounting Standard IAS 39, para 19(a)-(c).

2 *Lloyds TSB v Clark* [2002] UKPC41.

3 See HMRC *International Manual* INTM 332060 'DT applications and claims: Indofood: Impact on particular cases – Syndication and sub-participation'.

4 *Indofood International Finance Ltd v JPMorgan Chase Bank N.A. London Branch* [2006] EWCA Civ 158.

5 Perhaps the clearest definition by the English courts of 'interest' in a tax context is a 'payment by time for the use of money' (*Riches v Westminster Bank Ltd* [1947] AC 390 at 400). It is also noted that it is highly unlikely that a market standard sub-participation would constitute a 'debt' in the context of the UK loan relationships legislation owing to the absence of provision for repayment of the initial payment made by the participant to the lender of record. In this context, HMRC's published guidance notes that the 'general characteristic of a debt is that the creditor will at some time be repaid' (HMRC *Corporate Finance Manual* CFM 31030); this is a characteristic which would be absent from the LMA Funded Participation (Par) document.

6 For example, the exemption from withholding of income tax on payments of interest by a bank within the conditions in s 991 of the Income Tax Act 2007 ('ITA 2007') in the ordinary course of its banking business (s 878 ITA 2007).

7 *Campbell and Others v IRC* (1968) 45 TC 427 per Lord Donovan at 475.

8 *Earl Howe v Inland Revenue Commissioners* [1919] 2K.B. 336, *Asher v London Film Productions Ltd* [1944] 1 All ER 77.

9 See HMRC *Savings and Investments Manual* SAIM 8030, citing *CIR v Corporation of London (as Conservators of Epping Forest)* 34 TC 293 at 329.

10 The documentation in the LMA Standard Terms and Conditions for Par Trade Transactions (in particular at cl 10.4), incorporated as a default position under the LMA Trade Confirmation (Par), should be sufficient as a starting point to achieve this purpose.

11 If the entirety of an offshore participant's income is 'disregarded company income', as defined in s 816 ITA 2007, the participant's income tax liability will be capped at the level (if any) of any deductions made (or deemed to be made) at source or tax credits in respect of that income. Only if payments made under the sub-participation are neither interest nor annual payments (and result otherwise than from a transaction carried out by an independent broker or independent investment manager acting in the ordinary course of their business), would such payments be outside the scope of 'disregarded company income'. HMRC has in the past accepted that they would not seek to impose residual income tax charges on swap payments made to non-resident companies in these circumstances.

12 Section 6(2) of the Income Tax (Trading and Other Income) Act 2005.

13 See *LMA Memorandum*, Option 4, p 6.

14 Where such an SPV is located outside the UK, it may also be possible to add an additional argument as to why payments under the sub-participation agreement (or loan or total return swap) are not subject to any UK withholding of income tax on the basis that the source of the sub-participation payments might not be located within the UK: See HMRC *Savings and Investments Manual* para 9090 and *Kwok Chi Leung Karl (Executor of Lamson Kwok) v Comr of Estate Duty* [1988] STC 728.

15 See *LMA Memorandum*, Option 4, p 6.