DAC6: Application to Financial Products and Services: Sub-Participation Arrangements

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I. Introduction

In June 2020, AFME issued a paper (the "Financial Products and Services Paper") setting out a proposed common approach to address the application of the hallmarks in EU Council Directive (EU) 2018/822 ("DAC 6") to financial products and services[1]. The Financial Products and Services Paper identified five key principles, and discussed how those principles applied to derivatives, securities lending and borrowing, sale and repurchase agreements, and collateral transfers. In line with that approach, AFME sets out below how the same principles might apply to sub-participation arrangements.

II. Sub-participations

As part of their activities, financial institutions provide services to those who want exposure to fixed income products, such as loans. A financial institution will most usually act in its ordinary course of business as market-maker, matching (but not typically introducing or placing in direct contact) "sellers" that want to reduce their exposure with "buyers" who want to increase their exposure. The financial institution could also itself have originated a loan, or purchased loan inventory as part of its market-making function, and may offer exposure to investors in order to de-risk its own position and/or earn a margin on the transaction. In the majority of cases, the transactions operate via an assignment or transfer of the loan itself. There are, however, other mechanisms for providing exposure, and one of the main ways this is done for loan products is by means of a sub-participation.

Under an English law sub-participation, a financial institution (the "Grantor") who is the lender of record with respect to a particular borrower grants a sub-participation in that loan to a third-party investor (the "Participant"). The sub-participation can either be on a funded basis (where the Participant provides up-front funding to finance the Grantor's lending position) or on an unfunded basis (where the underlying loan has not yet been drawn, with the Participant agreeing to fund the Grantor to then fund any future drawdowns by the borrower). Whilst the underlying loan agreement and the sub-participation agreement are legally separate e contracts, the Grantor pays interest and repays principal on this sub-participation funding to the Participant to the extent that the underlying borrower itself pays interest and repays principal on the underlying loan.
In a typical English law sub-participation, the Participant takes credit risk against the Grantor as well as the underlying borrower. This is quite different from a traditional nominee or similar arrangement. If the Grantor becomes insolvent, the Participant will generally only have the right to claim as an unsecured creditor for unpaid amounts due under the sub-participation agreement (unless the Grantor has provided security over the Grantor's rights as lender under the underlying loan/security, or has provided some other collateral). In other words, as an unsecured creditor, the Participant would have to be subject to the general provisions of the relevant insolvency law and would deal with the administrator of the Grantor.

Other forms of sub-participations may also be entered into, for example under New York law. Unlike an English law sub-participation, New York law sub-participations typically result in the transfer to the Participant

[1] https://www.isda.org/a/d3bTE/AFME_ISDA-paper-on-application-of-DAC6-to-financial-products-and-services.pdf

of rights to the underlying loan itself, notwithstanding the Grantor retaining its status as lender of record . After sub-participation agreements are entered into, they are often in place until a loan matures or otherwise terminates. The Participant can, however, "elevate" its position before then and become lender of record with respect to the position, or transfer its interest in the sub-participation, with the usual consequence that the transferee "elevates" upon acquisition and becomes lender of record.

The following comments assume the sub-participation relates to the entirety of the lender of record's position under the loan, but it is perfectly possible that it is relates only to part of that position.

Sub-participations are common products, not geared or implemented in order to generate tax advantages, and are a feature of a fully-functioning debt market that, fundamentally, enables borrowers to access funding required for their real-world businesses. There are a number of non-tax reasons why an investor may choose to gain exposure to loans in such a manner rather than acquiring the position directly (e.g. by way of full transfer or legal assignment), including the following:

- Contractual: A loan document may (i) prohibit transfers/assignments or require that the borrower must consent to a transfer/assignment, (ii) require a lender of record to have a position of a size greater than the investor wants exposure to or greater than the amount the lender of record wants to transfer/assign; or (iii) require a lender of record to exhibit (or not exhibit) particular characteristics (for instance, requiring it is not engaged in certain types of business);
- Regulatory: A borrower's jurisdiction may treat lending as a licensed activity and the investor may not have the requisite regulatory authority to act as a lender of record; and
- Commercial: An investor may wish to keep the fact of its exposure confidential from other market participants.

III. Is the financial institution an intermediary for the purposes of DAC 6?

A financial institution will only be an intermediary if, broadly speaking, it (i) designs, markets and otherwise organises or structures a reportable arrangement (a "promotor"), or (ii) provides aid, assistance or advice in relation to an arrangement that it knows or has reason to know is a reportable arrangement (a "service provider").

Clearly, a financial institution ought to be aware if it is in the former category as a "promoter". Whether it is potentially in the second category as a "service provider" is a more difficult judgement, but AFME is of the view that, in the absence of specific knowledge about the tax position of the Participant, a financial institution acting as Grantor could not be regarded as being a service provider for typical market sub-participations. Where, unusually, the Grantor does have knowledge about the tax position of the Participant, AFME members take the following view in relation to the application of the hallmarks.

IV. Relevant hallmarks

AFME is of the view that if a determination has to be made as to whether a transaction falls within hallmarks, the key hallmarks worth considering in relation to market sub-participations are hallmarks A and B, both of which are subject to the "main benefit test".

It is appreciated that other hallmarks could be in point, depending on the facts of a particular transaction, but this would be highly unusual and likely already to be subject to increased scrutiny under existing governance processes at financial institutions. Since such situations are likely to be at the margins, they are not discussed in the comments below, which are intended to apply to the sorts of market flow transactions generally entered into.

Is there a main tax benefit arising from sub-participations?

In determining whether there is a main tax benefit arising as part of an arrangement, the key consideration relates to the withholding tax position of any interest paid by the underlying borrower. If the borrower jurisdiction does not levy a withholding tax on the borrower's interest payments regardless of the tax profile of the payee of such interest, there is no question of an interest withholding tax benefit (whether "main" or otherwise) arising from the arrangements. Similarly, often it is the case that the underlying borrower would withhold tax on payments to the Grantor at the same rate that it would have withheld tax on payments to the Participant, had the Participant been the lender of record. This includes a situation where exemptions from withholding tax apply to both the financial institution acting as Grantor and the Participant. In such cases, there is again no withholding tax benefit.

In some situations, however, it is possible that tax would be withheld by the borrower on an interest payment to the Participant had the Participant held the loan directly, but does not need to be withheld on interest paid to the lender of record.[2] This is more likely to arise where an English law sub-participation is concerned. Given the way a New York law sub-participation functions, and depending on the law of the relevant borrower jurisdiction, the Participant under a New York law sub-participation is more likely to acquire the beneficial ownership of the underlying loan, with the consequence that the Participant either: (i) suffers or is relieved from withholding tax on interest paid on that asset based on its own tax profile, or (ii) receives the interest subject to withholding tax at the full rate because the Grantor, as party to the loan agreement, is not able to represent to the borrower that the Grantor itself is entitled to benefit from any relief from withholding tax. In either outcome (i) or (ii), there remains no obvious withholding tax benefit arising from the arrangement.

Where there is a potential withholding tax differential in arrangements involving an English law sub-participation, a determination would then have to be made about whether this difference in withholding tax treatment could potentially constitute a main tax benefit, even if the underlying loan and the sub-participation are legally separate. For the reasons set out below, AFME members consider this should not generally be the case. Sub-participations are common in circumstances where a loan is distressed and the borrower may not be paying income on an underlying loan. Any perceived value in the position here tends to be based on how much of the principal outstanding under the loan is likely to be repaid. If no income is actually paid, there needs to be no consideration of any withholding tax impact and no main tax benefit can arise as a result of the difference in withholding tax rates, given the imposition of withholding is purely hypothetical.

If income is paid, or somehow imputed for tax purposes, the second point is that whether there is a tax benefit – main or not – implies that there is an economically similar transaction to an English law sub-participation where the tax benefit does not arise. As stated above, there are many circumstances where a Participant cannot make the loan directly, either because of a strict contractual or regulatory bar, or for commercial or administrative reasons (which, though they may not form a strict prohibition, may nonetheless be crucial from the perspective of the investor or financial institution). In such situations, a direct holding of the loan by the Participant should not be treated as a comparator transaction. As a result, in looking at whether a benefit arises at all the appropriate comparison is more likely to be another situation where the investor (the purported Participant) has exposure to the underlying borrower, but has neither direct contractual relations with the borrower nor any direct rights of ownership in relation to the borrower's assets. In that comparator transaction, it is likely that the withholding tax position would be exactly the same and therefore there is no actual "benefit" arising from the sub-participation.

If the Participant could in principle hold the loan directly and the withholding tax treatment of interest that would be paid to it is adverse compared to that of interest paid to the Grantor, the third point is that it is not clear how the Grantor would determine that this is a "main" tax benefit. As noted by AFME in the Financial

[2] For completeness, it is usually the case that no withholding tax applies to interest paid by the financial institution to the participant on any English law sub-participation funding. In the UK context this may be, for instance, because a UK financial institution benefits from an exemption from the requirement to deduct income tax under s 878 or s 885 Income Tax Act 2007.

Products and Services Paper, whilst a financial institution can generally be expected to be aware of an investor's strategy and broad commercial rationale – an awareness that helps it meet that investor's needs – it will not have the necessary detailed knowledge of such investor's overall position generally, let alone its tax position, to determine objectively the relative importance of the withholding tax analysis and whether the tax impact does indeed constitute a main benefit of the sub-participation. To put it another way, the financial institution is unlikely to have access to "all relevant facts and circumstances" in order to enable it to make a judgement.

Furthermore, and depending on the analysis of a specific fact-pattern, it may be determined that any withholding tax differential is a natural consequence of the legal arrangements and therefore consistent with the principles on which the relevant provisions relevant to the cross-border arrangements are based.

It could be that there are situations where (i) a Grantor is made aware by the Participant that there is a main tax benefit arising to it from the sub-participation, or (ii) a sub-participation is off-market in some material way, and heightened due diligence processes (including tax processes) are triggered which identify tax to be a main tax benefit of the transaction. In such situations the arrangement would be reportable if it falls within one of the hallmarks that require there to be a main tax benefit (as to which see below). However, for the reasons mentioned above, we do not consider it appropriate for a Grantor to be required to infer that there is a main tax benefit arising to the Participant from a market sub-participation based upon nothing more than a difference in hypothetical rates of withholding tax on interest, whether or not interest is actually paid on the underlying loan.

Hallmark A1 –confidentiality clauses

The confidentiality provisions related to sub-participations are usually documented in a separate confidentiality agreement between the Grantor and Participant. The terms can vary according to the risk tolerances of the parties but the aim of this agreement is to preserve the commercial confidentiality of the parties and to ensure that the Grantor is not in breach if its confidentiality obligations under the loan agreement. The confidentiality agreement is not drafted with an intention of preventing the disclosure of an arrangement where that is required by relevant law or regulation, and there is typically a carve-out in market templates allowing such disclosures (see, for example, paragraph 2.2(c) of the Confidentiality Letter (Purchaser) template prepared by the Loan Market Association (the "LMA"), dated 24 March 2011). Accordingly, hallmark A1 should not ordinarily be relevant.

For completeness, it is also worth noting that if this outcome did arise, this itself could trigger a reporting requirement under the UK Disclosure of Tax Avoidance Schemes rules, as well as corresponding rules in other jurisdictions.

Hallmark A2 – Remuneration related to tax advantage

The excess of (i) the funding received by the Grantor from the Participant, over (ii) the consideration the Grantor has provided to acquire or enter into a loan, represents the Grantor's "remuneration" or return on the transaction.

This amount should not ordinarily be regarded as either being an amount, or containing any amounts, "fixed by reference to" a tax advantage. This is because the amounts a Participant is willing to offer, and a financial institution willing to accept, depend on non-tax factors such as the extent to which the loan is in default and is regarded as distressed, the value of the borrower's underlying business, its credit rating, and the appetite of a Participant for a particular sector. It may even be that the funding provided by the Participant is less than the consideration previously provided by the Grantor, so there is no "excess" in any event. Further, in a market-standard sub-participation, amounts are paid by the Participant to the Grantor on a non-refundable basis: whatever the outcomes anticipated by the Participant, no amounts are returned to it by the Grantor if these outcomes are not obtained. It therefore follows that the Grantor's remuneration is not fixed by reference to any anticipated advantage, including any perceived tax advantage, that may be received by the Participant.

Hallmark A3 – Standardised documentation and structures

In Europe, sub-participations are typically entered into based on templates published by the LMA. Other organisations, such as the Loan Syndications and Trading Association (the "LSTA") in the United States, also publish similar templates, although (as noted) there are distinctions in the legal effect of different forms of agreement.

Like the template contracts produced by the International Swaps and Derivatives Association ("ISDA") and the International Securities Lending Association ("ISLA"), referred to in the Financial Products and Services Paper, the sub-participation agreements have been developed over time for commercial reasons and are intended to set out an agreed starting point for the rights and responsibilities of each party and for the allocation of commercial and legal risks, including tax risks. As with ISDA and ISLA documentation, LMA and LSTA sub-participation contracts have not been developed as tax products or schemes. As a result, AFME is here also of the view that, given the statements in the OECD BEPS 12 final recommendations about this hallmark (see paragraph 75 of the Financial Products and Services Paper) such sub-participation templates should not be seen as "standardised documentation" within Hallmark A3.

It should also be noted that the templates do not exist in isolation, and are typically tailored for each particular transaction with the inclusion in a schedule of provisions that the parties regard as fundamental to the commercial outcome. Even if there is some doubt about whether an LMA sub-participation agreement (for instance) is "standardised documentation", there should be little doubt that an agreement based the LMA template that is customised by terms in a related schedule or confirmation is not "standardised".

Hallmark B2—Conversion of income to capital or another type of income

In a standard English law sub-participation, where interest is paid on the underlying loan, the Grantor pays interest on the sub-participation. Similarly, where principal is repaid on the underlying loan, principal is repaid on the sub-participation. None of this should trigger hallmark B2. The payments are made on separate legal instruments, by and to different parties.

Even if the Grantor is looked through – which AFME does not think is the right approach, since this would ignore the legal arrangements entered into[3] – the character of the payment (namely, interest) received by the Participant is the same as that paid by underlying borrower. Even if such an analysis may be more appropriate when considering a standard New York law sub-participation, the same consequence applies.

Hallmark B3: Circular transactions

There is no circularity in a sub-participation. The underlying borrower's payment instigates (in an English law sub-participation) or comprises the totality of (in a New York law sub-participation) the chain of events, but there is no return to that borrower. As a result, hallmark B3 should not be in point.

[3] It is important to note that, as an English legal matter, the grantor does not simply pay on to the sub-participant amounts it receives from the underlying borrower. Rather, interest and other payments by the borrower trigger a payment by the grantor under a separate arrangement: the borrower's payment is the measure, rather than the source, of the grantor's payment (see Lord Hoffman's judgement in the Privy Council case *of Lloyds TSB Bank plc v. Paul Frederick Clarke and Chase Manhattan Bank Luxembourg SA (No.41 of 2002)*.

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