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Criteria

Legal Criteria for Withholding Tax Issues in Structured Finance Transactions

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Whenever cash flows across a jurisdictional border, there is a heightened risk that the tax authorities in the jurisdiction from which the cash left will require part of that amount to be remitted to it in the form of withholding tax. This is often the case in cross-border structured finance transactions, where cash is passed from payers in one country to an SPE issuer in another country. To the extent that an issuer's ability to make full and timely payment on its rated notes relies on these third-party payments, Standard & Poor's rating analysis will need to consider whether these payments are subject to withholding tax. This article describes which comforts Standard & Poor's will expect to receive to confirm that a rated transaction is not subject to withholding tax risk.

Where the Risk Arises

Withholding tax risk may occur in respect of payments under a swap and other derivative agreements entered into by the issuer for hedging purposes and any form of external credit enhancement, such as a letter of credit, liquidity facility, or guarantee. It may also arise on payments derived from a pool of underlying assets, such as loans, bonds, or other securities (collateral) and receivables that secure the issuer's rated obligations.

To the extent that any withholding tax is imposed on any of these payments, an equivalent amount will need to be deducted from the relevant transaction's cash flows in determining the amounts available to the issuer to meet its obligations under the rated notes. To obtain comfort that this deduction is not necessary, Standard & Poor's will wish to see the risk of withholding tax in a transaction either eliminated structurally or addressed legally.

Structural Comforts

Structurally, the risk of withholding tax is removed if the third-party payer is required to gross up its payment obligations so that the issuer receives the same amount it would have received had no such tax arisen. This assumes that the gross-up obligation is legal, valid, binding, and enforceable under the applicable law and that reliance on this gross-up obligation will create a rating dependency on the gross-up provider.

Alternatively, if the transaction can demonstrate that even net of applicable withholding tax there is sufficient cash flow to allow payment in full on the rated notes under the various stress scenarios, Standard & Poor's will not require any additional comfort on withholding tax risk.

Most often, however, express legal comfort will be required that there are no withholding tax risks to the relevant payments, as transactions are not usually structured so as to eliminate this risk.

Legal Comforts

Legally, comfort may be provided in the form of a legal opinion confirming that under the law of the jurisdiction of the third-party payer, no withholding tax obligation will arise on payments to the issuer.

Although opinions as to withholding taxes should come from external legal counsel, it may be appropriate in certain jurisdictions for these opinions to be given by qualified accountants with reputable firms. Also, in respect of withholding tax on swaps, derivatives, and external credit enhancement, it is acceptable to Standard & Poor's for these opinions to be issued by internal counsel to the relevant counterparty.

In lieu of these opinions, Standard & Poor's will also accept an unqualified written representation from counterparties in swap and derivatives transactions confirming that the relevant third-party payer is not liable to withhold tax from any payment to the issuer. The representation should be in a form commonly accepted in standard financial transactions (e.g., ISDA form tax representations). For certain types of credit enhancement, Standard & Poor's may also request that the enhancement provider delivers a similar representation.

In addition to withholding tax arising with respect to payments made by counterparties with whom the issuer

has directly contracted (e.g., swap counterparties and credit enhancement providers), this tax may also arise on payments from a pool of underlying collateral securing the issuer's obligations. If payments on the rated notes depend on payments from the collateral being made free of withholding tax, assurance is required that no withholding tax will be imposed. Once again, to the extent the risks are not eliminated structurally, as described above, robust legal comfort that there is no withholding tax risk will be required.

Typically, this comfort should be in the form of a legal opinion. Alternatively, in the context of CDO transactions, an unqualified written representation, in the form commonly delivered in standard financial transactions, from either the arranger and/or collateral adviser (as appropriate), will be accepted. This representation will be accepted in lieu of an opinion on the grounds that the arranger and/or collateral adviser will have undertaken the requisite legal due diligence to ensure that there are no withholding tax risks when structuring the transaction and selecting the collateral. For transactions involving revolving or ramp-up periods, Standard & Poor's will also expect the parties to the transaction to demonstrate that, post-closing, the transaction will not be subject to withholding tax risks. This comfort may, for example, be in the form of deemed representations or through the definition of the collateral's eligibility criteria, confirming that the collateral purchased after closing is not subject to withholding tax.

Additionally, in the context of CDO transactions, Standard & Poor's will accept a legal memorandum from tax counsel in the relevant jurisdiction stating that the collateral sold to the issuer does not attract withholding tax. Provided the specific collateral purchased by the issuer clearly falls within the ambit of the memorandum, Standard & Poor's will not require any further opinions or representations to be delivered on the issue of withholding tax on the collateral.

Standard & Poor's Requirements in Practice

Assuming one of the alternative forms of legal comfort described above is delivered in the context of a structured finance transaction, Standard & Poor's will generally not require legal opinions on withholding tax. On a case-by-case basis, however, the issue of withholding tax may be required to be addressed in a legal opinion. For example, opinions may be requested for new types of collateral or non-standard contracts, or to the extent that the debtor or issuer of the collateral is located in a jurisdiction where the issue of withholding tax is not well settled. As is current market practice, transaction counsel should contact Standard & Poor's legal department early in the rating process to determine what legal opinions will be requested for the transaction.

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