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Section 899 Implications for Foreign Banks Lending to US Borrowers through US Lending Offices

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In an earlier alert, we described the potential impact of the One Big Beautiful Bill on withholding taxes imposed on loans made by foreign banks to U.S. borrowers.[1] In that context, we noted that under existing loans any increase in U.S. withholding taxes would likely be passed onto the borrower under the terms of the credit agreement, and the borrower, at their own expense, would likely have the right to ask the lender to take actions to ameliorate the costs.

When a foreign bank lends to a U.S. borrower through a U.S. branch[2] or a U.S. corporate subsidiary there is no U.S. withholding tax imposed on the interest payments because the lender delivers an IRS Form W-8ECI (if lending through a branch) or an IRS Form W-9 (if lending through a U.S. corporate subsidiary). In the branch structure, the foreign bank will be filing a U.S. tax return and paying a corporate-level tax of 21% on its U.S. income and potentially the branch profits tax (BPT) on its after-tax income that is not reinvested in the business. In the U.S. corporate subsidiary structure, the lender is itself a U.S. taxpayer and it pays the corporate income tax at 21%, so there is no need for the U.S. to collect a withholding tax on the interest payments.

Section 899 nonetheless may impact the taxes of the foreign bank. In the branch structure, if the foreign bank is resident in a discriminatory foreign country (DFC)[3] the corporate income tax rate will increase by 5% and up to 20% if the country remains a DFC. So, the tax rate could conceivably go from 21% to 41%. In addition, the rate of BPT will also be subject to the rate increase.

In the U.S. corporate subsidiary structure, the corporate level tax will remain at 21%, but if the U.S. corporate subsidiary makes certain deductible payments (e.g., service fees, royalties, etc.) to related foreign persons the corporate income tax imposed can go up by 10%.[4] In addition, if the U.S. corporate subsidiary pays dividends to its parent company that is resident in a discriminatory foreign country, under Section 899, the U.S. withholding taxes will increase by 5%-20%, even if the parent company is resident in a country with which the U.S. has a tax treaty that provides for a reduced rate of tax.

Under the common terms of an LSTA agreement, the U.S. borrower should not be liable to bear the increase in the tax costs that the foreign lender incurs if it lends through a U.S. branch or a U.S. subsidiary. But it does mean that lending through a US branch or a US corporate subsidiary may well be less attractive to the foreign bank.

Our earlier alert suggested that in existing loans between a foreign bank and a U.S. borrower, the borrower may want to ask the lender to move the loan to an office where the U.S. withholding tax won’t be imposed. As described above moving it to a U.S. branch or U.S. corporate subsidiary may well be disadvantageous to the lender, so they may well not agree to such a request.

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[1] See this link for our prior alert that describes proposed Section 899 and the impact on the U.S. rate of withholding tax on interest on loans to foreign lenders. Briefly, the rate can be increased by 5-20% if the foreign lender is resident in a DFC. A DFC is one that imposes an unfair tax, which includes any digital service tax, diverted profits tax or a tax under the UTPR of the Pillar Two rules. All of the EU countries, Canada, and the UK have adopted one or more of those taxes and are DFCs.

[2] This includes loans made by subsidiaries of the foreign bank that are treated as disregarded entities for U.S. tax purposes.

[3] Or is controlled by a company that is a resident of a DFC.

[4] This is known as the Base Erosion and Anti-avoidance Tax (BEAT). Under current law, BEAT is imposed only if the U.S. corporate group has annual revenue of $500 million or more. Under section 899, if the U.S. corporate subsidiary is owned by a company resident in a DFC the threshold does not apply, so many more entities can be subject to BEAT.

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