Client Alert

Providing Strategic Legal Guidance to the Financial Services Industry

FINANCIAL SERVICES

JUNE 12, 2025

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"Revenge Tax"

What Section 899 Means for Foreign Lenders and US Borrowers

WITHHOLDING TAX RULES UNDER CURRENT LAW

Current US tax law provides for a 30% withholding tax on interest paid by a US borrower to foreign lenders. However, many foreign lenders are exempt from this tax, either under the "portfolio interest" exemption or under exemptions created by international tax treaties.

WHAT IS THE "REVENGE TAX"?

H.R 1, also known as the "One Big Beautiful Bill Act," contains a provision (Section 899) that could upset treaty-based exemptions to the withholding tax. If Section 899 passes, Treasury would make a list of "discriminatory foreign countries" which levy "unfair foreign tax[es]." Subject to certain exceptions, the withholding tax rate applicable to a lender that is a tax resident in a discriminatory foreign country would be subject to an increase of 5 percentage points per year (capped at 50%) for as long as that country's discriminatory policies remain in place. The tax increase would not apply to a foreign lender that relies on the portfolio interest exemption from US withholding tax but would apply to a foreign lender relying on a treaty-based exemption.

IMPLICATIONS FOR EXISTING CREDIT AGREEMENTS

a. Gross-Up Clauses

Section 899 could significantly raise the cost to US borrowers under existing standard-term credit agreements. Under these agreements, US borrowers generally bear "change of law" risk and are required to "gross up" lenders for new withholding taxes that become effective after a lender acquires an interest in the loan. These provisions are designed to ensure that lenders do not receive less than their initial expected return.

b. Mitigation and Lender Replacement Clauses

Section 899 could also cause complications for existing credit agreements with mitigation and lender replacement clauses. Mitigation clauses allow borrowers to request lenders to designate a different lending office when doing so would reduce or eliminate unforeseen new costs (including new taxes) and would not harm the lenders. However, if mitigation is ineffective or impossible, existing agreements may permit borrowers to require assignment of a loan to a lender that is not subject to such costs.

IMPLICATIONS FOR NEW CREDIT AGREEMENTS

For new credit agreements entered into in the lead-up to Congressional action on H.R. 1, lenders will want to include the standard gross-up clauses which protect them against change-of-law risk.

On the other hand, it is likely that borrowers will try to carve out "discriminatory foreign country" withholding tax increases from such gross-up clauses.