Indofood Decision: UK Tax Authorities' Guidance on Treaty Claims

London
October 23, 2006

1. Introduction

It is not often that the national tax authorities feel it appropriate to publish their views on a court decision in their own jurisdiction which had nothing to do with the taxes for which they are responsible. Indeed, in the case of **Indofood International Finance Ltd. v. JP Morgan Chase Bank, London Branch**[1], no tax administration was a party to the proceedings. The decision was that of the English Court of Appeal, and concerned a dispute over the terms of a note issue trust deed and related documents governed by English law. The parties to the litigation were the note issuer and the trustee. But the point concerned a change in tax law in Indonesia, the home country of the issuer's parent. It raised important issues relating to the interpretation of tax treaties and has caused considerable uncertainties in relation to financing structures, some of which are quite commonplace in the market. For that reason, and because the decision is now part of English law, HM Revenue & Customs ("HMRC") have felt it appropriate to set out how the decision will affect their approach to claims by non-residents under the UK's large network of tax treaties.

This memorandum discusses some of the important aspects of the **Indofood** decision on the tax aspects and HMRC's response as set out in their guidance published on 10 October. As a general point, the guidance is welcome. Equally welcome is HMRC's decision to publish it in draft form, with a view to inviting comments from interested parties. Their intention is to take these into account with a view to incorporating the guidance in their general practice manuals.

2. The Indofood Case

The **Indofood** facts concerned the issue of interest-bearing notes to the public by a Mauritian subsidiary of an Indonesian company, which was also the guarantor. The issue took place in 2002. Had the notes been issued directly out of Indonesia, they would have suffered 20% local withholding tax on interest. The insertion of the Mauritian subsidiary in the financing enabled local withholding tax to be reduced to 10%. The Mauritian subsidiary was able to claim the benefit of the reduced rate under the double

[1] [2006] EWCA Civ 158

tax treaty between Indonesia and Mauritius. There was also no further withholding tax in Mauritius, so it could pass on the benefit of the reduced rate to noteholders. Some two years after the issue of the notes, the Indonesian Government announced their intention to terminate the treaty with effect from 1 January 2005. This would have resulted in the Indonesian parent withholding tax at the domestic rate of 20% on interest.

Following the Indonesian announcement, the issuer triggered the tax call provisions of the notes and gave notice to the trustee of its intention to redeem early. Under the terms and conditions, the issuer was entitled to do this on an adverse change in Indonesian tax law if the effect of the adverse change could not have been avoided by the issuer taking “reasonable measures” to do so. The trustee, however, contended that the issuer had not taken reasonable measures, because a reasonable measure would have been to relocate the structure in a jurisdiction with which Indonesia had a similarly favourable tax treaty. The contenders were the Netherlands, Luxembourg and the United Kingdom, with the Netherlands being the most suitable. A restructuring would have involved the issuer assigning the onloan to a new Dutch subsidiary of the guarantor.[2]

The case was heard at first instance in the English High Court, where the trustee succeeded on the main substantive issues. The issuer appealed to the Court of Appeal. Various issues were heard by the Court. The issue which has given rise to HMRC’s recent guidance related to the question whether a newly interposed Dutch company would be the “beneficial owner” of the interest as required under the “Interest” Article of the Indonesia/Netherlands tax treaty.

The Court of Appeal determined the question of “beneficial ownership” in favour of the issuer. It held that a newly interposed Dutch company used purely to take advantage of the treaty would not be the beneficial owner of the interest and, therefore, the purported tax objective of any theoretical restructuring to avoid the 20% withholding would not be effective.

In coming to this conclusion, The Court of Appeal applied a so-called “international fiscal meaning” of the expression “beneficial ownership”. They based this on the Commentary to the OECD Model Treaty, which states:

“The term “beneficial owner” is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.”

They also placed considerable reliance on the published views of an eminent tax practitioner, Professor Philip Baker QC, regarded as a leading authority on tax treaties.

[2] A Dutch resident was also entitled to the favourable rate of 10% withholding tax on interest under the Indonesia/Netherlands tax treaty.

The application of the "international fiscal meaning" of beneficial ownership has caused a great deal of concern amongst the financial community. Many financial structures have been established with an intermediate entity claiming benefits under a treaty on the basis of beneficial ownership as known under English law. The Court of Appeal decision has given rise to the possibility that while those structures may be fine under domestic law, they may fail the international test. It is because of this uncertainty that HMRC have responded to the decision by publishing their draft guidance. The full text of the guidance can be found at

www.hmrc.gov.uk/news/indofood.pdf

3. The Draft Guidance

HMRC have published the guidance in draft form so as to give interested parties the chance to comment before the guidance is finalized. The guidance focuses purely on the question of "beneficial ownership", and not any of the other issues arising in the **Indofood** decision. HMRC recognize that the decision is part of English law. However, they seek to allay market fears by saying the decision is fully consistent with their policy. On that basis, they do not expect the decision to have significant impact on their existing practice in relation to treaty claims.

That practice includes taking appropriate action in treaty claim situations where it is apparent that there is treaty abuse e.g. treaty shopping. Denying a claim on treaty shopping grounds would effectively involve not accepting that it is sufficient for the claimant to demonstrate that it is the beneficial owner of the income in question under the appropriate local law. That is tantamount to applying the international fiscal meaning of beneficial ownership in such situations. So, where there is treaty abuse, HMRC believe that they are already applying this meaning. In other cases involving treaties, HMRC state that while the international fiscal meaning is relevant, its application is unlikely to produce a different result.

This general statement is welcome. HMRC then go on to consider specific examples of financing structures and to express their views as to whether those structures remain effective following **Indofood.** Some of these are discussed below.

Capital Markets Transactions Involving SPVs

The first example considered by HMRC is the use of special purpose vehicles ("SPVs") in the context of structures like securitization structures. In these structures, the SPV issues debt e.g. bonds to the market, invests the proceeds in a portfolio of receivables, and is effectively obliged to pass on returns on the receivables as payments on its debt (excluding a turn or fee). The terms of the documentation are likely to mean that the SPV's ownership of the receivables is likely to be fettered in a way that would mean it is not the beneficial owner under the international fiscal meaning. However, where the receivables are UK receivables, HMRC would not deny the SPV's claim for treaty relief if it is clear that the SPV has not been established in a treaty jurisdiction for treaty shopping purposes, but rather to maximize the return to a number of public holders of its debt. This is even more self-evident in the case of bondholders who themselves would be entitled to treaty relief had they invested in UK assets directly.

Quoted Eurobond Structures

"Quoted Eurobonds" are listed corporate debt securities carrying rights to interest. They may be bearer or registered. Interest payments on such securities are exempt from the basic UK requirement to withhold tax from UK source interest. Where an offshore SPV issues Quoted Eurobonds and invests the proceeds in UK unlisted debt instruments, it may be able to claim exemption from UK withholding tax on interest because of its treaty status. HMRC state that they would not deny the treaty claim in this situation, because there would be no withholding tax on the bonds issued by the SPV if the SPV were UK resident.

This view seems fairly generous as there could well be situations where the ultimate bondholder could not get exemption from UK withholding by investing in the UK instruments directly e.g. because it is not entitled to treaty protection. It would be unwise to assume that merely falling within the bare facts outlined by HMRC would be sufficient to withstand a treaty shopping challenge if the real predominant motive for interposing the SPV is to give a holder a UK withholding tax advantage.

Bank Lending and UK-Style Subparticipations

HMRC make it clear that they would take treaty shopping points in bank-lending structures where a bank is interposed merely because it is located in a favourable treaty jurisdiction and can pass on interest payments gross to another financial party who has not got such a beneficial treaty status. However, in cases where the intermediary has not been interposed for treaty shopping reasons, HMRC would again not view the lack of unfettered ownership and enjoyment of the assets by the intermediary as affecting its claim to treaty relief as beneficial owner. So, a conventional UK-style subparticipation where a bank lends to a UK borrower and subparticipates to other banks would not be affected. The lending bank would be regarded as the beneficial owner of the loan it makes to the UK borrower and the interest it earns. If it needs a treaty claim to get interest payments gross, the fact that it has obligations to pass on interest payments to the subparticipants would not matter.

The position would, however, be quite different if the rationale for the structure were driven by non-treaty subparticipants seeking to interpose a treaty bank just to get payments gross.

4. Existing Structures

HMRC also set out their views as to the impact of **Indofood** to existing structures. This is in response to concerns expressed that if the decision has wide-ranging effect, it would affect situations where interest is currently being paid gross to non-residents under accepted treaty claims. HMRC have adopted a pragmatic approach here and said that existing structures would be unaffected until the claim period has expired. They have no intention of applying **Indofood** retrospectively e.g. to interest payments which were made free of UK withholding prior to the decision. They do say, however, that this does not apply to cases where there was not full disclosure e.g. if they had previously raised questions regarding beneficial ownership and had not been advised of back-to-back arrangements. But even in these situations, if there was a genuine misunderstanding of the law by the claimant, claims for exemption from withholding will only be denied in relation to payments made after the decision.

One thing is clear moving forward: if there are treaty claims made by intermediaries in back-to-back structures, great care needs to be taken in completing the claim form to ensure that proper disclosure is made of the arrangement, including an explanation of the need for the back-to-back element.

5. Conclusion

HMRC appear to have adopted a sensible and pragmatic approach in considering the impact of the **Indofood** decision. There are, however, certain aspects of their approach which could benefit from further clarification. First, there seems to be an element of circularity in HMRC's view that an intermediary in a structure is not the beneficial owner under the international fiscal meaning because it has limited rights of ownership, but that may not matter if there is no treaty abuse. HMRC effectively state this in commenting on some of their own examples. The circularity arises because the question of treaty abuse itself is an integral element in the definition as set out in the OECD Model Commentary. So a better approach might be to look at back-to-back structures and just ask the question whether there is treaty abuse. If there is not, then the claimant should be the beneficial owner under both the domestic and international definitions.

Secondly, when HMRC look at whether the ultimate lender under a back-to-back arrangement could be better or worse off if it had lent to the UK directly, it is not clear how HMRC make the comparison. Their approach appears to be to look at the income paid by the SPV to the ultimate lender, and to ask whether withholding would have applied if that lender had lent on the same basis directly to the UK. They do not appear to consider it relevant to ask what would have been the position in the UK if the lender had been the party to the transaction under which the SPV is claiming treaty relief. For example, if an SPV issues discounted paper, but invests in interest-bearing debt in the UK, is the relevant comparison between discount or interest? The lender might suffer withholding on interest, whereas discount is not subject to withholding under UK domestic tax law. In this type of situation, HMRC have reserved the right to determine the issue in the light of all the relevant facts.

Overall, however, the guidance is helpful and should provide comfort to the financial community, although it is not quite "business as usual" as if Indofood had never happened.

* * * * *

If you have any questions on the text of this memorandum, please contact any of the following in the UK Tax Group, or, if you prefer, your normal tax contact:

Nikhil Mehta at +44 20 7614 2330 or via email at: nmehta@cgsh.com;

Kate Habershon at +44 20 7614 2260 or via email at: khabershon@cgsh.com;

Chris Hutley at +44 20 7614 2304 or via email at: chutley@cgsh.com;

Richard Sultman at +1 212 225 2675 or via email at: rsultman@cgsh.com.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 45 63 66 37 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 501 258 5006
7 501 258 5011 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax