Giving clearance

PAUL COOPER EXPLAINS THE SERIOUS IMPLICATIONS OF THE INDOFOODS CASE FOR TREASURERS MAKING PAYMENTS TO OVERSEAS LENDERS.

Executive summary

- HMRC published draft guidance late last year which could significantly change its policy on granting treaty clearances to allow interest to be paid gross in certain cross-border situations. This could give rise to an unwelcome additional tax cost of 20% of the interest, which may then be passed back to the borrower through gross-up clauses.

Where a UK company makes interest payments, it is required to withhold 20% of that interest and pass it over to HM Revenue and Customs (HMRC) as withholding tax, unless it can demonstrate that the lender qualifies for an exemption from withholding tax and can therefore receive the interest gross.

A particular problem arises where payments are made to overseas lenders. Relief from withholding tax may then be available under the double tax convention between the UK and the country in which the foreign lender is resident. But before payment can be made gross or at a reduced rate, a claim has to be made and accepted for each lender.

This has two implications for the treasurer. First, managing the treaty claims position is a time-consuming process. Second, and more importantly, if the process is not managed, any withholding tax cost is typically passed back to the borrower through a 'gross-up' clause in the loan documentation.

As such lending is often structured to minimise withholding tax exposures and the need to make treaty claims, one route is to use a special-purpose company located in a territory which doesn't charge withholding tax on interest payments and has a favourable tax treaty with the borrower's home territory. This special-purpose company can then lend to the market without any withholding tax issues and pass the proceeds back to the main group via an intercompany loan. There is then only a need to get a single treaty clearance to pay interest on the intercompany loan gross, which avoids having to manage numerous third-party claims.

Clearly, there may be many other good non-tax reasons to use special-purpose company structures and the tax benefit may be only a small part of the overall thinking, or even just a nice side effect of a decision made for other reasons.

Not surprisingly, tax authorities look at these structures with some suspicion and have attacked them where they feel they are being used for tax avoidance, by arguing that the special-purpose company did not have beneficial ownership of the back-to-back loan because its rights were so restricted. However, this argument was previously considered a hard one for HMRC to win from a UK tax perspective, particularly for territories like Luxembourg, which did not also have widely drafted 'anti-treaty shopping' clauses in their double tax convention with the UK.

WHAT HAPPENED IN INDOFOODS? The recent case of Indofood International Finance Ltd v JPMorgan Chase Bank NA concerned this type of conduit structure. The Indofood group was based in Indonesia and wished to raise external finance by issuing loan notes on the international market. If the group had done so directly it would have been obliged to deduct 20% withholding tax from interest payments under Indonesian law.

To reduce this burden the group established a Mauritian subsidiary, Indofood International Finance (IIF), which issued the international loan notes. There was no withholding tax liability on the interest paid by IIF on these notes. IIF then lent the funds it received to the parent of the Indofoods group, relying on the Indonesia-Mauritius tax treaty to reduce the Indonesian withholding tax liability on interest on this back-to-back loan to 10%. The net effect of this planning was to halve the withholding tax burden on the group to 10%.

But the Indonesian tax authorities decided to repeal the Indonesia-Mauritius double tax convention. The case came before an English court because under the terms of the bond agreement the loan note could be redeemed early only if there were no other 'reasonable measure' the borrower could put in place to address this additional

withholding tax cost. In the view of the agent for the bondholders other structures could be implemented. In particular, the Mauritian company could be replaced with a Dutch company so that the Netherlands-Indonesia double tax convention could be relied upon.

The English court was asked to consider how likely an Indonesian tax court would be to allow the new Dutch company the benefit of the Netherlands-Indonesia double tax treaty if the structure were implemented! At the Court of Appeal hearing it was held that the issuer did not have beneficial ownership of the interest on the intragroup loan for double tax convention purposes.

In particular, the court felt that on the facts as presented the new Dutch company would not have beneficial ownership of the interest on the intragroup loan as it did not have "full privilege of ownership to directly benefit from the income". Clearly, the Dutch company would have to use the interest it received to pay on as interest on the external investor loan notes and therefore did not have the full privilege of ownership of the income.

This is an important decision because if widely applied it will give HMRC much more scope to deny treaty benefits.

HMRC DRAFT GUIDANCE Following this judgement late last year, HMRC issued draft guidance outlining its suggested practice on claims for relief from UK withholding tax under the UK's double tax treaties.

To claim treaty benefits, an entity requires 'beneficial ownership' of the interest, royalties or dividends in question. HMRC says that to determine whether an entity has beneficial ownership it is necessary to consider an 'international fiscal meaning' rather than the 'narrow, technical' meaning of UK domestic law.

HMRC noted that in Indofoods the 'international fiscal meaning' of beneficial ownership was determined by reference to a test which required the recipient to "enjoy the full privilege to directly benefit from the income". The consequence of this is that if the recipients are bound in commercial and practical terms to pass on the income, then they are not beneficial owners of the income.

HMRC seems to be saying that it feels many structures involving back-to-back loans would not qualify for treaty benefits despite having done so in the past.

It goes on to say that this new interpretation is unlikely to be significant in many cases and should only arise where there is an improper use of a double tax convention. As a policy matter, where there is no avoidance of UK withholding tax through a conduit structure, HMRC says it will not refuse treaty clearance even if the conduit company does not have beneficial ownership under 'international fiscal meaning'.

POTENTIAL CONCERNS While the draft guidance says that HMRC does not consider the Indofoods decision will have a significant impact on its current practice, this seems at odds with some less formal comments from HMRC about what great news this case could be for it.

Also, many of the examples in the guidance note show situations where previously clearance would have been expected on a statutory basis and now would be denied under the strict international fiscal meaning but are allowed under the HMRC policy not to challenge situations which do not involve UK withholding tax avoidance. There is a concern this will introduce much more subjectivity into obtaining treaty clearances for many taxpayers.

The examples include a number of securitisation structures using offshore special-purpose vehicles, structures to borrow in the US commercial paper markets via US special-purpose vehicles, and group treasury operations centred in Luxembourg. The general message seems to be, that in HMRC's view at least, these structures can all be caught but then relief may be available on the basis there is no UK tax avoidance motive.

Many commentators are concerned that HMRC is seeking to apply the Indofoods verdict far too widely. It is applying a test of beneficial ownership which may have been appropriate under Indonesian law only (the 'full privilege' test) more widely than it should be. Indofoods was also an unusual case in that there was no margin on the back-to-back lending and so on, so the new Dutch company would have less real economic interest in the structure than would usually be the case.

WHAT DOES IT MEAN FOR THE TREASURER? At this stage the guidance is draft and HMRC may listen to the representations that have been made before making it final. One good feature of the guidance is that in the main it is not retrospective, so old clearances will not be revisited except in very limited circumstances.

But going forward, treasurers will need to reconsider their tried and tested structures for new cross-border lending to determine if an additional withholding tax burden could arise in the structure. In many cases there may be alternative structures which could be implemented to reduce the withholding tax burden.

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