What’s your view? Is Indofoods really ‘not just one Christmas present but two’ for HMRC? A Deputy Director of Revenue Policy reportedly expressed just such an opinion at an international tax conference earlier in the year.

The case (Indofood International Finance Ltd v JP Morgan Chase Bank (2006) EWCA Civ 158) (Indofoods) initially generated much consternation and scaremongering among practitioners and those involved in capital market transactions. The dust may have settled but until there is published guidance from HMRC (due in July but now said to be due in October), borrowers may be forgiven for taking a cautious approach in structuring transactions.

This article explores the reasons for such caution and looks at the practical impact of the case in the six months since March 2006.

First a recap
In 2002 Indofood International Finance Ltd, a Mauritian special purpose vehicle (the SPV), issued US$280 million 10.375% loan notes that were guaranteed by its Indonesian parent company (the Parent). The proceeds of the loan notes were lent by the SPV to the Parent under a separate loan agreement, which was governed by Indonesian law. The Parent paid interest under the on-loan to the group. The Parent could have taken to avoid the withholding obligation and suggested that a Dutch SPV could be interposed to enable the Parent to continue to pay interest at a withholding tax rate of 10% – relying on the Indonesia/Netherlands tax treaty.

As English law governed the redemption provision in the notes, the matter came before the UK Court of Appeal.

The decision
The Court had to determine whether there were any measures that the SPV or the Parent could have taken to avoid the obligation to pay more than 10% withholding tax. If so, was it reasonable to require them to take those measures?

For the Indonesia/Netherlands tax treaty to apply, the Dutch SPV had to be the beneficial owner of the interest received under the on-loan to the group. The concept of beneficial entitlement is common in many double tax treaties. It prevents abuse of the advantageous withholding tax regime, as the recipient of the interest must be able to show that it is fully entitled to enjoy the benefit of the interest.

Avoided by the SPV taking ‘reasonable measures’!

The Court determined that, under the loan arrangements, a Dutch newco would not enjoy beneficial ownership of the interest. Accordingly, the interposition of a new SPV was not a reasonable measure available to the Parent or the Mauritian SPV, because of the likelihood of the Indonesian tax authorities mounting a successful challenge. The SPV was entitled to redeem the notes.

Beneficial ownership and implications
In considering beneficial ownership, the Court of Appeal took account of guidance applied by the Indonesian tax authorities that (not unsurprisingly) did not regard the Dutch SPV as being the beneficial owner of the interest. The guidance said that an entity would only be the beneficial owner if it had full right and privilege to benefit directly from the income. The judges also considered the official commentary to the OECD model convention, which explains the beneficial ownership limitation in the model agreement. This looks to economic tests and regards entities as mere ‘administrators’ where their powers over income and assets are narrow. Against this backdrop, the Court of Appeal decided that the Indonesian tax authorities would not regard the new SPV as being the beneficial owner of the interest.

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The Court argued that, by establishing a new company, the Parent could have taken to avoid the increased withholding obligation. This was unless the more onerous withholding obligation could be
Can a new meaning of beneficial owner be applied to all UK treaties where the expression beneficial ownership is used? Can the ordinary English law meaning be displaced where parties are involved in treaty shopping? The uncertainty left in the wake of Indofoods has, according to some, opened the door for HMRC to attack hitherto accepted funding structures.

It had been understood that representations by some law firms to HMRC would lead to clarification of the approach that HMRC would take to different types of financing transactions in the light of Indofoods. However, despite various suggestions from HMRC that guidance would be published mid-summer, nothing has been forthcoming yet. If, as suggested, guidance is now imminent we look forward to some clarification of the issues.

Practical impact
When the ramifications of Indofoods were first considered, reactions were varied; ‘potentially devastating’ to ‘irrelevant’ were words used to describe the impact on the cross-border finance industry. A publication by Standard and Poor’s shortly after the Court of Appeal decision raised an early warning and Stephen Edge’s article in this publication (Issue 833, 17 April 2006) indicated the potentially wide impact of the case. Many feared the adverse effect on inward investment to the UK and the relief available to pension and other investment funds.

Recent transactions
In recent deals we have seen, concerns by advisers have led to restructuring some typical finance deals to avoid the potential Indofoods impact. Whilst there is little concern that the case could have any impact on a typical commercial securitisation and many other commercial cross-border financing transactions (and the unofficial soundings from HMRC suggest as much), the lack of official guidance would be published mid-summer, nothing has been forthcoming yet. If, as suggested, guidance is now imminent we look forward to some clarification of the issues.

Likely outcome
It is our view that Indofoods will eventually have a narrower application than initially feared. After all, Indofoods was not a tax case. The facts were very particular and many UK double tax treaties already have specific anti-avoidance articles to combat blatant treaty shopping of the type contemplated in Indofoods.

In the Indofoods case the Court took account of the fact that, for example, the SPV was a simple pass-through vehicle and was contractually bound to pay on all amounts from the Parent and that the payment dates under the loan and the notes correlated. Most tax practitioners would not be surprised should HMRC seek to attack the use of such conduit companies, which are no more than pass-throughs in back-to-back arrangements. In that regard, Indofoods is simply another weapon in HMRC’s armoury.

A range of factors needs to be in place to help prevent HMRC calling into question the arrangements. For example, there should be commercial justification for the SPV; the loan terms for the financing on either side of the SPV should be specifically thought through; the vehicle needs economic substance and, ideally, some leeway to apply its income. In this way, SPVs in many securitisations and syndicated lending structures, where their use makes economic sense and there are strong arguments for their beneficial ownership of income, should be outside the scope of Indofoods.

In the meantime, the lack of direction from HMRC after its initial reaction leaves us in a climate of unnecessary ambiguity and we look forward to the promised guidance to give some much-needed clarity.